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Shareholders Versus Managers: The Strain in the Corporate Web

John C. Coffee Jr.
Columbia Law School, jcoffee@law.columbia.edu

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SHAREHOLDERS VERSUS MANAGERS: THE STRAIN IN THE CORPORATE WEB

*John C. Coffee, Jr.**

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* Adolf A. Berle Professor of Law, Columbia Law School. — Ed.

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"We have entered the era of the two-tier, front-end loaded, bootstrap, bust-up, junk-bond takeover."

— Martin Lipton¹

Until recently, takeovers typically involved larger firms digesting smaller firms, a process that most theorists have assumed was driven by the pursuit of synergistic gains.² Lately, however, this dynamic has dramatically reversed itself. To a considerable extent, the large conglomerate is now the target, and such prototypical conglomerate firms as General Foods, Richardson-Vicks, Beatrice, Revlon, SCM, CBS, USX, and Anderson, Clayton and Co. have either been acquired or forced to restructure themselves within the last three years alone.³ The new bidder in turn tends to be a financial entrepreneur — either a

1. Lipton, *Takeover Abuses Mortgage the Future*, Wall St. J., Apr. 5, 1985, at 16, col. 4.

2. See, e.g., Bradley, Desai & Kim, *The Rationale Behind Interfirm Tender Offers: Information or Synergy?*, 11 J. FIN. ECON. 183 (1983) (rejecting the undervaluation rationale for tender offers based on evidence that the stock prices of targets that successfully resisted a takeover eventually declined to pretakeover levels). For a review of the various theories advanced to explain takeover activity, see Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1162-75 (1984).

3. Until recently, even in the largest transactions, the scale of the bidder generally exceeded that of the target. Thus, such mega-mergers as DuPont's 1981 acquisition of Conoco for \$10.7 billion, U.S. Steel's 1981 purchase of Marathon Oil for \$7.3 billion, and the two giant acquisitions of 1984 — Chevron's purchase of Gulf for \$13.3 billion and Texaco's acquisition of Getty Oil for \$10.1 billion — fit this pattern in that all were "friendly" deals by large bidders having related operations into which they intended to assimilate the target. Only in the Chevron deal was the acquirer (the fifth-largest oil firm) slightly smaller than the target (Gulf being then the fourth-largest firm). See K. DAVIDSON, *MEGAMERGERS: CORPORATE AMERICA'S BILLION-DOLLAR TAKEOVERS* 263-64 (1985). The year 1984 appears, however, to have been a turning point, as the Chevron-Gulf marriage was in fact a shotgun wedding precipitated by Boone Pickens' siege of Gulf. Subsequently, such individuals as Carl Icahn, Saul Steinberg, Asher Edelman, Irving Jacobs, Robert Holmes a Court, Charles Hurwitz, and the Belzberg brothers have led small groups of individuals or relatively small firms in takeover bids for much larger targets. During 1985, Carl Icahn took control of TWA; Asher Edelman, Datapoint; Sir James Goldsmith, Crown Zellerbach; Irving Jacobs, AMF; and Ronald Perelman (the CEO of Pantry Pride), Revlon. See Worthy, *What's Next for the Raiders*, FORTUNE, Nov. 11, 1985, at 21. In most of these cases, the "junk bond" financing arranged by these bidders necessitates that they

single individual or an ad hoc collection of individuals, smaller entities, and investment banking firms — who intends not to assimilate the target, but to dismantle it. Since 1984, we have entered the era of the “bust-up” takeover — that is, a takeover motivated by the perceived disparity between the target’s liquidation and stock market values. A new breed of financial entrepreneur, originally typified by Carl Icahn and Boone Pickens, but more recently expanded to include major investment banking firms acting for their own account, has appeared on the scene, who essentially arbitrages this difference between stock and asset value by first acquiring control and then partially liquidating the target in order to pay down the acquisition indebtedness.⁴ Tactically,

liquidate a substantial portion of the target’s assets to amortize these short-term bonds. See note 5 *infra*.

A particular target of this new takeover wave has been the conglomerate firm (whereas earlier waves focused on oil and natural resource companies). During 1985, General Foods Corporation was acquired by Phillip Morris Inc. without a fight; Richardson-Vicks Inc. accepted a “white knight” bid from Proctor & Gamble in preference to a hostile bid from Unilever, N.Y. See Prokesh, *Food Industry’s Big Mergers*, N.Y. Times, Oct. 14, 1985, at D1, col. 3. Revlon Inc. eventually was acquired by Pantry Pride Inc. for \$2.7 billion after various attempts by Forstman, Little & Company to arrange a leveraged buyout either fell through or were enjoined by the Delaware courts. See Cole, *High-Stakes Drama at Revlon*, N.Y. Times, Nov. 11, 1985, at D1, col. 3. CBS escaped a proposed \$5.4 billion hostile takeover bid made by Ted Turner, after spending nearly \$1 billion to buy back 21% of its stock. See *CBS’s Debt Bomb*, FORTUNE, Aug. 5, 1985, at 8. Subsequently, Loews Corporation bought a 25% interest in CBS, making its victory seem potentially Pyrrhic. See *Loews Plans to Buy Up to 25% of CBS; Gets a Seat on Board*, N.Y. Times, Oct. 17, 1985, at A1, col. 6. Finally, Hanson Trust, an English conglomerate, emerged victorious over Merrill Lynch in a battle for control of SCM Corp., another conglomerate. See Brown, *Hanson Trust’s U.S. Thrust*, FORTUNE, Oct. 14, 1985, at 47.

4. For a good description of the organizational structure of these new bidders, which consist of loose networks of individuals and entities that have been assembled by entrepreneurs such as Carl Icahn, see Penn, *Raiding Parties: Friends and Relatives Hitch Their Wagon to Carl Icahn’s Star*, Wall St. J., Oct. 2, 1985, at 1, col. 6. The economic motives of these new takeover technicians are entirely orthodox. They are simply pursuing a profit opportunity that is not available to ordinary shareholders, who cannot feasibly coordinate to force management to liquidate a corporation whose liquidation value exceeds its going concern value. Such bidders are, however, more constrained in their options for the target than traditional corporate bidders because the financing arrangements available to these entrepreneurs usually require a speedy amortization of the acquisition indebtedness (in part because the debt component of the acquisition price is much larger in cases where small groups of individuals make the bid than when a much larger corporation does). Thus, plans to dismantle the target and sell its assets in piecemeal fashion to third parties are often in place and negotiations for resale in progress even before the takeover has succeeded. See Crudele, *Rorer Buys Drug Unit of Revlon*, N.Y. Times, Nov. 30, 1985, at A29, 31, col. 6 (noting that Pantry Pride had negotiated sale of Revlon’s drug unit to Rorer even before the tender offer had succeeded, in order to arrange its financing). Similarly, Ted Turner at the outset of his bid for CBS indicated the various CBS properties that he wished to sell. See Smith, *Turner Offer for CBS; Wall St. Skeptical on Success*, N.Y. Times, Apr. 19, 1985, at A1, col. 1, D9, col. 5. Quaker Oats Company acquired Anderson, Clayton & Company for \$812 million in 1986 and then announced that it would retain only one division, the Gaines pet food line, and sell the majority of the assets. See Phillips, *Back to Basics at Quaker Oats*, N.Y. Times, Nov. 29, 1986, at 37, col. 3. As a result, although the bust-up takeover has its precursors and all takeovers threaten the job security of the incumbent target management, the distinctive pattern (and underlying financing arrangements) associated with these transactions implies that asset divestitures and substantial layoffs are marginally more likely.

The newest development in the behavior of bidders has been a further growth in their scale associated with the appearance of major investment banking houses (Merrill Lynch, Morgan

it is easy enough to explain how this new era has arrived: new financing techniques — most notably, the appearance of the “junk bond” in late 1983 — have vastly extended the capability of the smaller bidder, by allowing it to borrow more and to use the liquidation value of the target as its collateral.⁵ What is more puzzling is why discounts between a firm’s asset and stock market value have arisen that are sufficiently large to justify multi-billion dollar takeover contests.⁶ Even

Stanley & Co., Bear Stearns, First Boston Corp.) as joint venturers in the bid who actually make a substantial equity investment in the target. See Sterngold, *Wall St. Buys Into the Action*, N.Y. Times, June 19, 1986, at D1, col. 3. Even more recently, these same investment banking houses have begun to play a merchant banking role by directly advancing short-term or “bridge” financing to the bidder. In a recent competitive battle for Allied Stores, First Boston committed \$1.8 billion of its own capital to its client bidder, while Shearson Lehman committed to lend \$1.6 billion to its client. In another recent deal, Merrill Lynch & Co. has agreed to lend \$1.9 billion of its capital to Sir James Goldsmith. See Sterngold, *Market Place: Wall St. Deals: Ante Is Raised*, N.Y. Times, Nov. 6, 1986, at D10, col. 2.

Courts have also recognized the special nature of the bust-up takeover and hinted that they may justify defensive tactics not otherwise appropriate. See *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 180-81 n.12 (Del. 1986); *Moran v. Household Intl., Inc.*, 500 A.2d 1346, 1349 n.4, 1356-57 (Del. 1985).

5. The most complete description of this new form of takeover financing is contained in a report prepared by the Congressional Research Service for the House Subcommittee on Telecommunications, Consumer Protection, and Finance. See CONGRESSIONAL RESEARCH SERVICE, 99TH CONG., 1ST SESS., *THE ROLE OF HIGH YIELD BONDS [JUNK BONDS] IN CAPITAL MARKETS AND CORPORATE TAKEOVERS: PUBLIC POLICY IMPLICATIONS* (Comm. Print 1985) [hereinafter CONGRESSIONAL RESEARCH SERVICE REPORT]. For a revealing description of the unique nature of this “junk bond” market, see Sloan & Rudnitsky, *Taking in Each Other's Laundry*, FORBES, Nov. 19, 1984, at 207. Essentially, “junk bonds” are bonds rated at below “investment grade” by the two principal bond rating agencies (Moody’s or Standard & Poor’s); such bonds pay a correspondingly high interest rate, with current rates equalling 16% or more. Prior to 1976, no well-known investment banking house would underwrite the original issue of such low-rated bonds, but in that year Drexel Burnham Lambert, which had previously made a secondary market in these bonds, began also to underwrite them. The use of junk bonds to finance takeovers apparently dates from the “latter part of 1983.” See CONGRESSIONAL RESEARCH SERVICE REPORT at 23. The significance of the junk bond’s appearance is twofold: First, bidders, such as Boone Pickens, Victor Posner, Saul Steinberg, or Pantry Pride (all of whom have financed tender offers through Drexel Burnham) had previously had difficulty in obtaining credit from banks, some of whom have refused to finance “raiders” as a matter of policy. Second, commercial banks have traditionally followed conservative lending policies and have seldom been willing to finance more than 50% of the acquisition cost of a target, thus compelling bidders in the past to raise the balance from retained earnings. Yet, commercial banks have no objection to bidders incurring additional debt that is subordinated to their own loans (because from the standpoint of these banks such subordinated debt is the equivalent of equity). Thus, a bidder who can issue subordinated junk bonds (at a high interest rate) after first borrowing from commercial lenders (at a lower rate) can today finance as much as 90% of the acquisition cost. Junk bond financing appears central to the newfound ability of small bidders to tender for much larger targets. As of 1985, the percentage of junk-bond financing in hostile deals was about 25% of the aggregate financing (as opposed to only 6% in friendly deals), and this figure rose to 33% in the case of the 30 largest tender offers in 1985. See Securities and Exchange Commission, Office of the Chief Economist, *Noninvestment Grade Debt as a Source of Tender Offer Financing*, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,011, at 88,168 (June 20, 1986) [hereinafter SEC, *Noninvestment Grade Debt*].

6. A good illustration of this phenomenon is CBS, whose shares ended 1984 at \$72.37 (up slightly over \$6 for the year). Yet when Ted Turner made his bid for CBS, offering a package of securities that he valued at \$175 a share and the market valued at around \$150, the consensus of securities analysts placed a break-up value on CBS at “between \$180 and \$200 per share.” See

more anomalous is the apparent ability of target managements, when confronted with a hostile takeover bid, to undertake a financial restructuring, themselves, that substantially reduces the size of this discount.⁷ Why then did the discount persist for so long? If the contemporary takeover market is driven by the existence of these discounts, none of the conventional theories of the takeover supplies a satisfactory explanation for this phenomenon. The standard synergistic model cannot easily account for why the bidder seeks to dismantle the target, rather than integrate its operations with its own. Similarly, the more controversial disciplinary thesis, which holds that superior managements are displacing inferior ones, cannot explain why even the best operationally managed companies seem to experience such disparities between asset and stock value, and the "private information" theory, which assumes that the bidder knows something that the market does not, cannot be reconciled with the fact that the existence and size of such discounts are apparently well known to the market.⁸ Nor can any of these theories easily account for the bidder's belief that value is to be maximized by reducing the target's scope of operations by selling off or closing down marginal divisions. This article will offer an alternative explanation for what is occurring — one that is intended not as a definitive account of all takeover activity, but as a partial explanation of those trends that raise the most serious social issues.

In overview, the market for corporate control is now largely complete. Few, if any, American corporations are today beyond the reach of this market because of their size or scale. The appearance of the bust-up takeover and the new financing arrangements undoubtedly facilitated this closing-off of the market, but other factors also contributed. For the future, the important question is: where is this transition leading us? The heightened threat of the takeover has clearly been abrupt and decisive in several respects. First, its appearance has coincided with a sudden shift toward higher corporate leverage that has alarmed the Federal Reserve Board and produced the first mild intervention by that agency into the field of takeovers.⁹ Concom-

Vartan, *Market Place: Putting a Value on CBS Assets*, N.Y. Times, Apr. 22, 1985, at D6, col. 3. In effect, the securities industry here saw the liquidation value of this conglomerate at between two and three times its stock market value and reached this valuation without regard to management's skill or operational plans.

7. See notes 144-65 *infra* and accompanying text.

8. Because the bidder in a bust-up takeover secures financing from the junk-bond market based not upon his own credit, but on the perceived disparity of asset and stock values, his success in securing such financing shows that the debt market shares his judgment and considers his asset valuation of the target to be highly credible. This shared public consensus is obviously inconsistent with the possession of private information about the target's value. See note 6 *supra*.

9. In late 1985, by a 3-2 vote, the Federal Reserve Board announced a proposed restriction

itant with this shift has come an unprecedented spate of restructuring by large corporations; indeed, between January 1984 and mid-July 1985, 398 of North America's 850 largest corporations engaged in such restructurings,¹⁰ largely, it will be argued, as a means of discouraging or preempting a hostile takeover.¹¹ Especially common have been corporate share repurchases, up from \$3.6 billion in all of 1981 to \$19.4 billion in just the first six months of 1986.¹² These repurchases have vastly exceeded the amount of new equity capital issued over this period, and the resulting erosion in the equity base of American corpo-

on the use of junk bonds issued by "shell corporations" to finance takeovers. Effectively, the Federal Reserve's action means that debt securities issued by such "shell corporations" might not be issued to finance more than 50% of the purchase price in a takeover. Procedurally, the Federal Reserve Board established a presumption that debt securities issued by a "shell" corporation were "indirectly secured" by the target's stock when no other credit or assets were pledged. However, the Board defined "shell corporation" narrowly as one having "virtually no business operations, no significant business function other than to acquire and hold the shares of the target, and virtually no assets or cash flow to support the credit other than the margin stock it has acquired or intends to acquire." See *Interpretation of Margin Requirements*, 72 FED. RES. BULL. 192 (1986). Based on this definition, the professional reaction to the Federal Reserve Board's ruling was that creative planning by bidders could overcome this presumption, particularly if other security for the loan (such as a guarantee by those who stood behind the shell corporation) were also pledged. See Hershey, *Federal Reserve Votes for Limits on Debt Financing of Takeovers*, N.Y. Times, Dec. 7, 1985, at 1, 36, col. 3. Moreover, between the rule's original proposal in December 1985 and its issuance, it was sufficiently weakened as to be today largely ineffective. See Smith, *Fed Rule Restricting the Use of Junk Bonds in Takeovers Is by Most Accounts Ineffective*, Wall St. J., Aug. 18, 1986, at 47, col. 3. One tactic is to issue a "junk" preferred stock and then later refinance it with a debt issuance in connection with the follow-up merger. *Id.* Moreover, the Federal Reserve is unwilling to characterize a bidder as a "shell corporation" simply because the minnow is in effect swallowing the whale. When Pantry Pride acquired Revlon, Pantry Pride had annual revenues of only \$110 million as opposed to Revlon's \$2.4 billion. Yet, the Federal Reserve acknowledged that Pantry Pride was not a shell corporation. *Id.* For the text of the Federal Reserve's rule, see 51 Fed. Reg. 1781 (1986) (to be codified at 12 C.F.R. § 207.112) ("Purchase of Debt Securities to Finance Corporate Takeovers"). See also notes 113-28 *infra* and accompanying text.

10. See *Surge in Restructuring is Profoundly Altering Much of U.S. Industry*, Wall St. J., Aug. 12, 1985, at 1, col. 6. According to this survey, some 52 of these restructurings were classified as forced by a takeover, while the rest were viewed as "voluntary." This assumption that restructurings that occur prior to a definite takeover bid are not takeover-induced seems simplistic because it ignores the "ex ante" impact of the takeover threat. See notes 144-70 *infra* and accompanying text.

11. A word is necessary about why a financial restructuring protects the corporation against a takeover when it essentially shrinks the corporation's equity base. At least two explanations can be given: First, the repurchase of shares, either for cash or notes, may inflate the percentage of stock held by management or its allies if they do not tender. An example is the recent restructuring by Colt Industries, in which over \$1.5 billion was paid out to shareholders, while the percentage of stock held by Colt's retirement savings plan rose from 7% to over 30%. See Gilman, *Colt Industries Offers Proposal to Recapitalize*, Wall St. J., July 21, 1986, at 2, col. 4. Alternatively, the recapitalization may pay out to shareholders assets that were hoarded by risk-averse managers, see text at notes 50-60 *infra*, with the result that the corporation's asset value on a liquidation is brought more closely in line with its stock value, thereby reducing the incentive for a bust-up takeover. Other reasons may make stock repurchases an effective, but coercive, defensive tactic after a hostile bid has been launched. See Bradley & Rosenzweig, *Defensive Stock Repurchases*, 99 HARV. L. REV. 1377, 1393-1400 (1986).

12. See Williams, *Corporate America Buys Itself Back*, N.Y. Times, Aug. 17, 1986, at F1, col. 2. In 1985 buybacks totaled \$37 billion, up from \$17 billion in 1984. *Id.*

rations has given rise to a new catchword — the “decapitalization” of America.¹³ Finally, as a result of both restructurings and the increased number of hostile bids and leveraged buyouts, the status of the manager within the large public firm has been adversely affected. Unlike the earlier takeover movement, which primarily threatened senior management, the brunt of this new wave of control changes is being substantially borne by middle management. By some estimates, 600,000 or more “white collar” managerial positions have been eliminated in recent years as the result of corporate restructurings and similar efforts to trim excess staff.¹⁴

The implications of this transition upon the managerial labor market have been insufficiently recognized. Once employment security was an element of the “implicit contract” that the manager had with the firm, but today that relationship has been significantly altered. Because substantial managerial layoffs are now likely after either a hostile takeover or a friendly “white knight” transaction or restructuring,¹⁵ the prior pattern of career employment within a single firm may

13. According to a recent Salomon Brothers study, restructurings, including buybacks, are running at \$110 billion a year, while new shares are being issued at a \$60 billion annual rate. See Williams, *supra* note 12, at F6, col. 1. In 1984, the total value of outstanding equities dropped by \$83 billion (about 4.5 percent) and in 1985 by \$63 billion. See CHAIRMAN OF HOUSE SUBCOMM. ON TELECOMMUNICATIONS, CONSUMER PROTECTION AND FINANCE OF THE HOUSE COMM. ON ENERGY AND COMMERCE, 99TH CONG., 2D SESS., RESTRUCTURING FINANCIAL MARKETS: THE MAJOR POLICY ISSUES 40, 274-79 (Comm. Print 1986) [hereinafter RESTRUCTURING FINANCIAL MARKETS]. As one economist testifying before this House subcommittee phrased it, we are “decapitalizing significant portions of our industrial sector, which is disquieting at best in a capitalistic society.” *Id.* at 40 (testimony of Michael C. Connor).

14. See Greenhouse, *Surge in Prematurely Jobless*, N.Y. Times, Oct. 13, 1986, at 21, col. 2, 24, col. 3 (natl. ed.). The macroeconomic impact of these layoffs is a matter of speculation and controversy among economists, but at least some economists have estimated that in 1985 takeovers and related transactions “cost the economy 0.5% to 1% in GNP.” Jonas, Berger & Penar, *Do All These Deals Help or Hurt the U.S. Economy?*, BUS. WK., Nov. 24, 1986, at 86, 87 (quoting Edward Hyman of Cyrus J. Lawrence, Inc.).

15. Substantial managerial layoffs have been common in the wake of larger mergers, particularly in the recent “oil patch” mergers where the acquiring firm essentially wants only the oil reserves of the target and already possesses excess refining capacity of its own. Thus, in the wake of the Chevron-Gulf acquisition in 1984, the combined entity laid off 10,000 employees (or 12% of its work force), and it further reduced its work force by 2000 in 1985. Following Texaco’s acquisition of Getty Oil, Texaco announced a 26% reduction in its work force. See Schmitt, *Depleted Field: Despite Raiders’ Lust, Oil Industry Is Facing Retrenchment Period*, Wall St. J., June 7, 1985, at 1, col. 6. Nor is this pattern unique to the oil industry. Following Baxter Travenol Laboratories’ acquisition of American Hospital Supply Corporation, plans were announced to lay off 10% of the combined work force, or 6000 workers. See *Baxter Plans Layoffs; Merger is Completed*, N.Y. Times, Nov. 26, 1985, at D2, col. 3. Even when the bidder is defeated, the target may be compelled to trim its work force substantially as the result of the added leverage it took on in connection with its defense. For descriptions of layoffs at CBS, Martin Marietta, and Phillips Petroleum following “successful” takeover defenses, see sources cited at note 131 *infra*.

Of course, changes in the product market and foreign competition are also responsible for these developments by making some industries unable to sustain the prior number of firms in them. While this explanation has considerable validity for the oil industry, it does not explain the takeover wave in broadcasting (where licensees have de facto monopolies) or the food indus-

no longer be a realistic expectation. Over the long run, this development could change the internal culture of the American corporation, force significant revisions in the structure of managerial compensation, and affect the economy as a whole. As a result, the takeover context cannot be sensibly viewed as simply a private law problem, but instead requires analysis from a public law perspective.

A major contention of this article is that these developments are altering the character of the American corporation, in terms of its goals, its span of operations, the behavior of its managers, and its ability to compete against foreign rivals. These are not modest claims, and they also may not seem to be legal ones. Yet, from a public law perspective, the internal restructuring now under way within American corporations should be viewed as a logical, even overdue, corrective response, compelled by market pressures, to a long-standing managerial bias in favor of corporate growth and inefficient size-maximization. Still, abrupt transitions usually produce casualties, and a recurring concern of the law has been how to cushion the impact of such transitions, either by slowing their pace or offering compensation.¹⁶ This article will examine three critical leverage points at which legal rules can moderate the speed of the transition or mitigate the severity of the injury to those most exposed to loss.

First, the existence of substantial discounts between asset and stock values implies a failure in existing managerial compensation practices. If managers have a bias for inefficient expansion that reduces the firm's value, it must be asked why compensation formulas cannot be devised that correct this problem by creating a stronger in-

try. In these areas, layoffs in the wake of financial restructurings more closely resemble wealth transfers from employees to shareholders.

Few decisions have yet dealt with whether employees can object to merger-related dismissals as violations of their employment rights. *Compare* *Kumpf v. Steinhaus*, 779 F.2d 1323 (7th Cir. 1985) (employee had no right to continuing employment in wake of restructuring of his corporation), *with* *Ohanian v. Avis Rent a Car*, 779 F.2d 101 (2d Cir. 1985) (oral contract for lifetime employment upheld). For purposes of this article, it will be assumed that the employment-at-will doctrine still generally holds throughout this context.

16. For a provocative overview of "transition policy," see Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509 (1986). This article will view the changed position of the manager within the American corporation as at bottom involving an issue of transition policy. Should the law seek to compensate or mitigate the effects of transition on the manager? Professor Kaplow argues that generally the law should not intervene, because market solutions for allocating risk are preferable to governmental remedies. Yet, there are two distinctive elements to the special context here under review: First, the usual market solutions for dealing with risk — *i.e.*, insurance and diversification — are less available to the manager as a means of protecting his investment, for reasons involving his undiversifiable investment of human capital in the corporation. Second, the law in a number of respects precludes market solutions, either by subjecting certain forms of managerial compensation to legal uncertainty or by precluding certain managerial defensive tactics (*i.e.*, the leveraged buyout). Thus, one objective of this article is to assess how the law should evaluate potential market solutions to the problem of risky investments in human capital.

centive for managers to “listen to the market” and pursue only growth or investments that the stock market (and thus shareholders) value. The further one probes into this topic of optimal compensation arrangements between shareholders and managers, the more difficult the problem of designing an optimal compensation system begins to appear. Economic theory suggests that shareholders and managers have struck an “implicit contract” under which managers forgo current income in return for security and deferred compensation.¹⁷ Under any such arrangement, however, opportunistic behavior by shareholders is possible; that is, instead of paying the deferred compensation or providing the promised security, they can replace management through the vehicle of hostile control contests and thus renege on the implicit contract. In this view, the hostile takeover has disrupted the old system of implicit contracting and necessitated that a new one be designed. Normally, such a task might be left to private ordering, but private ordering as a solution here encounters several difficulties. First, the law may block any ex post attempt to settle up with managers or employees as a fiduciary violation; second, those most exposed to risk — namely the middle management level — are the constituency least represented in this final period. Finally, the most predictable and legally least vulnerable response to decreased job security is to pay the manager a risk premium. This technique may, however, be the least efficient, because it overcompensates managers in those firms not taken over, fails to restrict lateral transfer (as a system of deferred compensation does), and may be extremely costly to shareholders to the extent that risk-averse managers demand a high risk premium. Thus, in the belief that an ex post system of compensation has important efficiency advantages, this article advocates a policy of “premium sharing” that seeks to induce both shareholders and senior management to redistribute takeover gains more broadly.

A second point of contact between the law’s concerns and the developing new configuration of relationships within the modern public corporation involves the law’s attitude toward leveraged buyouts (“LBOs”) by the target firm’s management. In overview, this article will suggest that the LBO is a predictable response to the firm’s inability to develop optimal compensation arrangements. Faced with expo-

17. See sources cited at notes 62 & 65 *infra*. The use of contract analogies to analyze corporate governance issues has been strongly criticized by some commentators. See Brudney, *Corporate Governance, Agency Costs, and The Rhetoric of Contracts*, 85 COLUM. L. REV. 1403 (1985). Although this author partially disagrees with both Professor Brudney and the neoclassical proponents of contract law analysis, the reference in the text to “implicit contracts” is intended here only to frame the issue, not to assume the appropriate form of analysis. See notes 196-221 *infra* and accompanying text.

sure to a loss of expected security and deferred compensation, managers must either buy control of the firm from its shareholders or somehow obtain voting control by other means. Increasingly, the LBO appears to be the only viable response to the hostile bid that avoids the de facto liquidation of the target corporation.¹⁸ Although a strong case exists for preferring this alternative on a variety of both private and public law grounds, recent judicial decisions have been uniformly hostile to any efforts by the target company to favor the LBO alternative.¹⁹ On their specific facts these decisions are understandable, but they create uncertainty. A clearer standard is therefore desirable by which to judge how much of a thumb, if any, the target corporation may place on the scales to favor a leveraged buyout in which its own officers are interested. Moreover, in this context as in that of severance compensation, a consistent policy of premium sharing requires that greater judicial attention be given to the interests of employees and middle managers, who are sometimes the clearest losers in leveraged buyouts.

Third, from a public law perspective focused on minimizing any externalities associated with the new takeover wave, an issue of overriding importance is the scope of authority open to state regulators. Legally, this issue implicates the constitutionality of the "second generation" of state takeover statutes.²⁰ Recent decisions have almost uniformly struck down these new statutes.²¹ With the Supreme Court's recent grant of certiorari in *CTS Corp. v. Dynamics Corp. of America*,²² the issue is posed whether state law may place any burden on the market for corporate control, even under the guise of regulating traditional matters of corporate governance long accorded to state regulation. After examining several possible standards, this article will argue that state regulation explicitly addressed to protecting the interests of nonshareholder constituencies merits considerable judicial deference and is most likely to meet the benefit/burden comparison that the Court framed as its test in *Edgar v. MITE Corp.*²³ Such statutes (of which the New York statute is the closest prototype)²⁴ would not prevent a change in control, but could seek to prevent takeovers from

18. See notes 226-31 *infra* and accompanying text.

19. See notes 232-35 *infra* and accompanying text.

20. See notes 249-91 *infra* and accompanying text.

21. See notes 251-52 *infra* and accompanying text.

22. 794 F.2d 250 (7th Cir.), *prob. juris. noted*, 107 S. Ct. 258 (1986).

23. 457 U.S. 624 (1982).

24. See N.Y. BUS. CORP. LAW § 912 (McKinney 1986) (discussed at notes 276-79 *infra*).

effecting wealth transfers from employees and related interest groups to shareholders.

Before advocating specific reforms, this article will first seek in Part I to understand how the takeover is changing the configuration of relationships within the modern corporation. In doing so, it will advance a model of the firm that sees the interests of shareholders and managers as fundamentally in conflict over the issue of risk. Such a perspective differs from most recent commentary on the hostile takeover, particularly in the following respects:

First, most critiques of the takeover have been relatively narrow and ad hoc. Thus, we are recurrently told that hostile takeovers divert managerial attention, enforce a myopic concentration on the short run, or discourage investment in research and development.²⁵ Little attempt has been made by these critics to relate their views to a broader theory of the firm. In contrast, this article will suggest that the implications of the hostile takeover can only be understood in terms of a basic tension between managers and shareholders that preexisted recent developments but which has been substantially intensified by them.

Second, both proponents and critics have framed their arguments as if takeovers were a game that involved only shareholders. Given this "no externalities" assumption, they have both focused on how a particular policy toward takeovers would affect shareholders' wealth. Thus, those who have defended managerial defensive tactics have simply argued that such tactics are in the shareholders' long-run interest, either because they promote a value-maximizing auction or because they otherwise protect shareholders from an exploitative takeover at a price below the firm's "intrinsic" value.²⁶ Conversely, proponents of competitive bidding in takeovers have viewed the process as simply a "competition among management teams" for control of the corporation's assets.²⁷ The problem with this "fair game" perspective is that those playing this game may trample on the interests of nonpartici-

25. For representative examples of these critiques, see R. REICH, *THE NEXT AMERICAN FRONTIER* 140-72 (1983); Drucker, *Corporate Takeovers — What Is To Be Done?*, 82 *PUB. INTEREST* 3 (1986); Fogg, *Takeovers: Last Chance for Self-restraint*, *HARV. BUS. REV.* Nov.-Dec. 1985, at 30; Hayes & Abernathy, *Managing Our Way to Economic Decline*, *HARV. BUS. REV.*, July-Aug. 1980, at 67; Loescher, *Bureaucratic Measurement, Shuttling Stock Shares, and Shortened Time Horizons: Implications for Economic Growth*, *Q. REV. ECON. & BUS.*, Winter 1984, at 8; Williams, *It's Time for a Takeover Moratorium*, *FORTUNE*, July 22, 1985, at 133.

26. See, e.g., Lipton, *Takeover Bids in the Target's Boardroom*, 35 *BUS. LAW.* 101 (1979); Lipton, *Takeover Bids in the Target's Boardroom: An Update After One Year*, 36 *BUS. LAW.* 1017 (1981); cf. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 *HARV. L. REV.* 1028 (1982); Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 *COLUM. L. REV.* 249 (1983) (arguing for extended takeover offer period).

27. See Bradley & Rosenzweig, *Defensive Stock Repurchases*, 99 *HARV. L. REV.* 1377 (1986).

pants. The standard assumption of economics that voluntary exchanges produce social gains fits the takeover context rather easily, but, precisely because of this close conceptual fit, proponents of this mode of analysis tend not to look for impacts on others. Yet, predictably, there are affected bystanders — most notably, managers and employees, but also creditors and ultimately the state as well — who will change their behavior as the significance of the takeover's impact grows on them. Over time, the process is a dynamic one, and defensive reactions must be expected from these other constituencies that will in turn affect shareholders.

That little attention has been given to the claims of these other constituencies is in large part attributable to the popularity of a model of the firm that sees shareholders as the principals and managers as their agents. Although recent theorists have tended to view the firm as a complex web of contracts,²⁸ this article will argue that they have stopped short of realizing the full implications of this point and continue to see the shareholder as the only residual risk bearer and the only party needing contractual or governance protections. Traditional economic theory sees the other participants in the corporate contract as receiving a largely fixed return that is essentially determined by external market rates.²⁹ As a result, it is assumed that the shareholder, as the critical actor who alone has accepted the entrepreneurial role, is entitled to appropriate the full takeover premium. This analysis is flawed, however, if managers and others also share in the residual risk and are seldom protected fully by the external market.

Others have, of course, also asserted that hostile takeovers can produce diseconomies. The problem with their ad hoc critiques is that, if accepted, they prove too much and could be used to justify a total prohibition of hostile takeovers. Moreover, this species of "horseback empiricism" is largely unverifiable in the absence of any commonly accepted benchmark and also begs critical normative questions. For example, when one asserts that market forces pressure managers to

28. See, e.g., Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Cheung, *The Contractual Nature of the Firm*, 26 J.L. & ECON. 1 (1983); Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Fama & Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). For a critical review of this mode of analysis, see Brudney, *supra* note 17.

29. This is most true in the neoclassical model of the corporation, as formalized by such thinkers as Frank Knight. See F. KNIGHT, *RISK, UNCERTAINTY AND PROFIT* (1921). More recent theorists have emphasized that employees develop firm-specific capital on the job, which factor converts the corporation into an internal job market. See M. AOKI, *THE CO-OPERATIVE GAME THEORY OF THE FIRM* 25-26 (1984); Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1207-09 (1984).

concentrate on the short run, the obvious retort is: Why shouldn't they do so if this is what shareholders want? If shareholders today demand a higher discount rate or simply have a shorter time horizon in an inflationary world, a critic must explain why this change is not as much within the shareholders' prerogative as it is to shift their political preference from Democrat to Republican. A coherent response is possible only if we admit the possibility that social wealth and shareholder wealth can diverge.

Once this possibility is acknowledged, a divergence between shareholder and managerial preferences does not necessarily imply that the former need to be able to subject the latter to tighter control. To be sure, the takeover may sometimes properly discipline management, but it also may disrupt a preexisting web of contracts by which shareholders and managers had reached an equilibrium position between their conflicting interests. To say that the capital market is disciplining management only identifies the process but leaves unresolved the question of the direction in which we are moving. This article will answer that question by arguing that the new wave of takeover competition is moving us toward acceptance of a higher level of risk at the firm level. This movement may be in the shareholders' interest, but it is far from clear that it is in the interests of society as a whole.

Because the bust-up takeover appears to be the driving force in this transition, Part I will seek to understand why firms trade in the stock market at a substantial discount from their asset value. It will answer that existing theories of the firm have not given adequate attention to a critical area where shareholders and managers have an inherent conflict, one that the existing structure of the firm does not resolve or mitigate. Despite the significant changes in the internal structure of the corporation over the last half century that have been described by business historians,³⁰ there remains a deep internal strain between shareholders, on the one hand, and managers and employees, on the other. The central conflict involves the asymmetry in attitudes toward risk held by the typical manager and the typical shareholder. Put simply, the rational manager has good reason to be risk averse, while the fully diversified shareholder has every reason to be risk neutral. If we see the modern public corporation as — in the phrase currently fashionable among theorists — a “web of contracts,” this conflict over risk preferences is the strain in the corporate web that best explains the

30. See A. CHANDLER, *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* (1977). Chandler's description of the rise of managerial specialization and the development of internal control mechanisms is discussed at notes 84-86 *infra*.

significant disparity between stock and asset values that invites bust-up takeovers.

Based on this analysis, Part I will suggest that in its current operation the hostile takeover should be conceived less as a device by which "good" managements drive out "bad" than as a means by which shareholders can impose their own risk preferences on more risk-averse managements. To be sure, this is not the exclusive role of the takeover. Takeovers also seek to realize a variety of synergistic gains.³¹ Yet, for the last three years, the bust-up takeover has predominated (at least in terms of its impact on both the media and management), and its principal contemporary impact has been to serve as a coercive measure by which managers are induced to accept risks that they would resist on their own. Indeed, takeover competitions among various bidders and the incumbent management begin to look increasingly like contests that are determined by the relative willingness of the contestants to accept risk, as each side proposes in turn a radically more leveraged capital structure. Part I will develop this argument by first examining the ways in which the principal models of the firm have implicitly, but inadequately, recognized that shareholders and managers have conflicting attitudes toward risk. Then, it will survey the two recent developments that show the new impact of the takeover: (1) the movement towards "deconglomeration," and (2) the increase in corporate leverage.

Part II of this paper will then focus on the possible diseconomies associated with a higher tolerance for risk, in particular as the problem is compounded by the impact of increasing corporate leverage. Although no level of risk aversion or preference is necessarily optimal from a social perspective, Part II will decompose the corporation into its separate constituent interests and assess the changed positions of creditors, employees, and the state as the ultimate insurers of residual corporate liabilities.³² The practical question will be the extent to which visible flaws in the bargaining process justify regulatory intervention.

Part III will then turn to this article's proposed policy of premium sharing, and Part IV will thereafter examine the other earlier-noted

31. For a fuller critique of this disciplinary hypothesis, see Coffee, *supra* note 2, at 1163-66. Essentially, the disciplinary thesis cannot account for the cyclical-wave character of takeover movements (because incompetence does not occur in waves) and cannot easily explain why the worst-managed firms, such as International Harvester or Chrysler (before its change in management) have seldom been the objects of takeover attempts.

32. For an excellent example of this approach, which identifies the various categories of participants and the relationships among them, see Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521 (1982).

junctures at which the law can influence the pace and impact of the transition now in progress. Other alternatives also exist, including revised voting rules that reduce the voting power of large shareholders or a policy of encouraging greater employee ownership in the corporation.³³ Recently, there have been movements in each of these directions, and the trade-offs among them need evaluation. In particular, these alternatives need to be examined because the one option on which much legal commentary has focused — enforcing a rule of managerial passivity in the face of a hostile takeover — seems an increasingly futile hope.³⁴

I. WHAT HATH THE TAKEOVER WROUGHT: A SURVEY OF THEORIES AND EVIDENCE

A little over fifty years ago, Berle and Means reported that the separation of ownership and control in the modern corporation had left shareholders effectively powerless, as managers could neither be ousted from office by shareholders who were widely dispersed, and therefore incapable of coordinated action, nor disciplined effectively by the capital market — at least so long as managers could rely on internal cash flow to finance corporate expansion.³⁵ Almost everyone who has since written on the theory of the firm has used the Berle and Means thesis as a point of departure.³⁶ Much recent work has shared two characteristics: First, it has seen the manager as having less autonomy than Berle and Means thought, because the manager's own self-interest would lead him to install various monitoring and bonding

33. Unequal or "super" voting stock has also become a major issue within the last year after over a half century of unquestioned public acceptance of the New York Stock Exchange's "one share, one vote" rule. Its appearance is also testimony to the repercussions of the new takeover wave. See notes 209-10 *infra*. New devices to encourage employee ownership, such as the ESOP, have also recently become popular. See discussion at note 210 *infra*.

34. Managerial passivity in the face of a takeover was the legal rule favored by Professors Easterbrook and Fischel in their well-known article. See Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981). Others have argued for a modified passivity rule that would permit only auction-enhancing tactics. See Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981). Although this author is sympathetic to the latter approach, it has made little headway with the courts, which continue largely to favor the business judgment rule's applicability to this context. For recent decisions in the federal courts, see, e.g., *Radol v. Thomas*, 772 F.2d 244, 255-58 (6th Cir. 1985); *Gearhart Indus. Inc. v. Smith Intl. Inc.*, 741 F.2d 707, 721 (5th Cir. 1984). For the recent Delaware decisions, see note 225 *infra*.

35. A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

36. Proof of this contention can be found in a Symposium on Berle and Means published by the *Journal of Law and Economics* on the fiftieth anniversary of their book's publication. See *Corporations and Private Property*, 26 J.L. & ECON. 235 (1983). John Kenneth Galbraith has termed the book, with Keynes' *The General Theory of Employment, Interest and Money*, one of the two most important books of the 1930s. See Galbraith, Book Review, 13 ANTITRUST BULL. 1527 (1968).

devices in order to maximize the value of his own shares in the firm.³⁷ Second, it has rejected the view of the firm as "owned" by shareholders in favor of a view that conceives of the firm as an equilibrium position achieved as the result of bargaining among the various participants, including managers, shareholders, and creditors.³⁸

Viewed in this light, the fundamental irony surrounding the modern bust-up takeover is that it may be taking us full circle back to the apocryphal era that Berle and Means assumed once existed when managers were in fact dutiful agents of shareholders. If bidders perceive that a firm's assets can be liquidated at a value in excess of the firm's stock value plus the necessary takeover premium to acquire control, they will launch a hostile tender offer. Managers know this, and therefore the permissible range for managerial opportunism is reduced, even if few bids are actually made. But what explains this margin between asset and stock value sufficient to justify current takeover premiums as high as 100% or more, when modern institutional economics has steadfastly argued that managers also desire to maximize the firm's stock price? Answering this puzzle will provide the starting point for this article's analysis.

A. *The Central Problem of Risk*

Shareholders and managers can potentially have many conflicts: salary, dividends, self-dealing transactions, etc. All these and other conflicts have long produced disputes that sometimes reach the courts. Recent theorists of the firm have argued, however, that it is in the interests of both sides — managers and shareholders — to resolve these conflicts in advance through a variety of contractual devices and institutional mechanisms. Different as the theories of Oliver Williamson and Michael Jensen will be seen shortly to be, they agree that those conflicts between the interests of shareholders and managers that most worried Adolf Berle and Gardiner Means a half century ago have been largely mediated and resolved today.³⁹

37. See sources cited at note 28 *supra*.

38. In this view, the shareholder is not the "owner," but the "residual risk bearer," who uniquely has the taste for risk that allows him to accept the highest variance surrounding his expected return. See Fama & Jensen, *supra* note 28, for a representative statement of this view. Once we view the shareholder as simply a specialist in risk bearing, there may still be persuasive efficiency arguments as to why he should exercise control (as Fama and Jensen argue), but the normative force inherent in the concept of ownership is lost.

39. From the perspective of Jensen & Meckling, *supra* note 28, this conclusion follows because the stock market will discount the shares of those corporations whose managements are perceived as behaving opportunistically (at least more so than average), thus reducing the value of the managers' own wealth to the extent they hold shares in the firm. For Williamson, the rise of the M-Form Firm implies that a new monitoring apparatus has come into being that can better check managerial opportunism. Thus, he suggests that "the corporate control dilemma

Whether or not one accepts this contention that the traditional problems of corporate law have been solved, economic theory suggests that there is one area of conflict that was never addressed, even recognized, by the traditional law of fiduciary duties and that remains very much unresolved today. Modern financial theory assumes that rational shareholders will hold diversified portfolios. Although there is some evidence that individual investors do not in fact hold well-diversified portfolios,⁴⁰ this generalization certainly fits institutional investors, who today dominate the marketplace.⁴¹ In any event, it seems clear that investors, whether individual or institutional, are better diversified than managers. Managers are inherently overinvested in the firm they serve, for at least three distinct reasons.

First, the manager's most important asset is his or her job. Although the manager generally does not have a recognized property right in his employment relationship with the corporation, this relationship still has a present value to the manager equal to the discounted earnings stream he or she expects to receive from that job (or career path) until retirement. Both because lateral mobility among senior corporate executives is limited and because the manager may develop firm-specific human capital,⁴² the manager cannot assume the existence of an external market rate of return applicable to his or her labors, as the lower-echelon employee may be able to assume. Rather, the still prevailing pattern is one in which there are "ports of entry" within the corporate hierarchy, but little opportunity exists for lateral movement at an equivalent level.⁴³ Because managerial compensation

posed by Berle and Means has since been alleviated more by *internal* than it has by regulatory or external organizational reforms." Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 J. ECON. LIT. 1537, 1560 (1981) (emphasis in original).

40. For evidence that investors in fact frequently hold undiversified portfolios, see Blume & Friend, *The Asset Structure of Individual Portfolios and Some Implications for Utility Functions*, 30 J. FIN. 585 (1975); M. BLUME & I. FRIEND, *THE CHANGING ROLE OF THE INDIVIDUAL INVESTOR* 46-50 (1978). Of course, it is possible that these investors' holdings of other risky assets (such as real estate) compensate for this apparent failure of rationality.

41. Institutional investors now own at least 35% of all shares on the New York Stock Exchange and even higher levels of corporations in the Standard & Poor's 500 stock index. See Lowenstein, *supra* note 26, at 297-98.

42. Firm-specific capital is essentially a subset of the problem of asset specificity. See Williamson, *supra* note 39, at 1548-49; Williamson, *supra* note 29, at 1207-08, 1215-17. Such capital could arise either because of specific job training or technological skills the manager acquires, which are not equally valuable to other firms; it also may arise because of the significance of "corporate cultures," which necessitate that special interpersonal skills be acquired to function in individual corporate environments. See T. DEAL & A. KENNEDY, *CORPORATE CULTURES: THE RITES AND RITUALS OF CORPORATE LIFE* 16-18, 83-84 (1982); W. OUCHI, *THEORY Z: HOW AMERICAN BUSINESS CAN MEET THE JAPANESE CHALLENGE* (1981). The assimilation difficulties that acquiring firms often experience in absorbing target firms may corroborate the significance of this culture barrier.

43. For an economic overview of the labor market within the firm, see P. DOERINGER & M. PIGORE, *INTERNAL LABOR MARKETS AND MANPOWER ANALYSIS* (1971); Mortenson, *Specific*

is thus set within an internal market, the loss of a job means more to a manager than to those employees whose wages are determined by an external market. To sum up, the basic contrast is that shareholders own many stocks, but managers have only one job.

Second, the manager is over-invested in his own firm because the firm in its own interest awards him a generally nontransferable interest in itself through stock options and other fringe benefits. Empirically, there is no doubt that senior managers do in fact have a substantial portion of their personal wealth invested in their own firm.⁴⁴ The firm's purpose is to align the manager's interests with those of the shareholders. This concept of aligning managerial and shareholder interests is at the very heart of the Jensen and Meckling model, which demonstrates that most shareholder/manager conflicts can be minimized in part through such incentive compensation.⁴⁵ However, for present purposes, the relevant point is that the use of stock as compensation gives the manager an undiversified portfolio. Ironically, while this device cures other conflicts it cannot resolve the asymmetry in risk attitudes between shareholders and managers.

Third, although shareholders have limited liability, managers and directors may well have personal liability in the event of corporate insolvency or financial distress. Recent experiences at Continental Illinois, Trans-Union, Chase Manhattan, and Bank of America indicate that corporate managers can be sued from all directions: in derivative actions, in governmental proceedings, in class actions under the federal securities laws, and by bankruptcy trustees.⁴⁶ In some circum-

Capital and Labor Turnover, 9 BELL J. ECON. 572 (1978). These writers have suggested that promotion ladders and unvested pension benefits are mechanisms by which the firm could hold onto the services of an executive who possessed firm-specific capital. See also O. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 57-80 (1975). Historically, the rate of turnover among managers, particularly top managers, has been low. See W. MCEACHERN, MANAGERIAL CONTROL AND PERFORMANCE 30-31 (1975). There are signs, however, that it has recently increased as a direct consequence of the prevalence of hostile takeovers. See Coffee, *supra* note 2, at 1235-37.

44. See Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J.L. & ECON. 375, 389-90 (1983); De Alessi, *Private Property and Dispersion of Ownership in Large Corporations*, 28 J. FIN. 839, 848 (1973); W. LEWELLEN, THE OWNERSHIP INCOME OF MANAGEMENT 150-51 (1971) ("The annual income of executives depends very heavily, very directly, and very persistently, on the dividends received and capital gains experienced by such men in their roles as both stockholders of their employer companies, and as beneficiaries of stock-related compensation arrangements.").

45. See note 28 *supra*.

46. The officers and directors of Continental Illinois have been sued both by shareholders and by the FDIC, which suits remain pending as of this date. The board of Continental decided not to oppose certain of these suits against former officers. See Williams, *Continental Cites Lax Lending*, N.Y. Times, July 23, 1984, at D1, col. 6. The directors of Trans Union were found to have recklessly breached their duty of care in accepting a merger proposal without considering other candidates. See *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). Senior bank officers at both Chase Manhattan and Bank of America have been directly sued by their own corporations.

stances, they may even face criminal liability for securities fraud or other offenses if, after insolvency, there surface allegations that they hid the corporation's financial distress.⁴⁷

As a result, the bottom line is that the manager may not view corporate insolvency with the same equanimity that the diversified shareholder can. Because the manager cannot spread his risks, or escape them safely in the event of insolvency, he is economically wedded to his firm. The implications of this point are at once obvious and far reaching: managers will be more risk averse than their shareholders. Indeed, it is axiomatic that fully diversified shareholders should be risk neutral. Portfolio theory divides the risk associated with any security into two components: a *firm-specific* component and a *systematic* or nondiversifiable component associated with general market conditions.⁴⁸ Once a shareholder has diversified his portfolio, he is in theory largely immune from firm-specific risk, both because no individual stock should have a major impact on his portfolio's performance and because his portfolio will include countercyclical stocks whose price movements will tend to offset each other. Hence, the investor should in theory be risk neutral. Under some circumstances, he may even behave as a risk preferrer, because he may seek stocks having a high risk level to offset the debt or low-risk components of his portfolio. The manager, however, has no real protection against firm-specific risk and thus will be risk averse. This is both inevitable and in some respects desirable, because, if the manager could diversify away all firm-specific risk, serious moral hazard problems would arise and the senior manager would have little incentive to monitor others.

Once this conflict is recognized, it can be seen to constitute an underlying tension that runs through the corporate landscape much like the San Andreas fault — that is, seldom overtly visible in its operation,

See Glaberson, *Is Chase Opening the Gates to Negligence Suits by the Boss?*, BUS. WK., Nov. 5, 1984, at 39. Possibly in consequence, directors' and officers' liability insurance has become increasingly hard to obtain, and recent newspaper reports suggest that directors have become extremely anxious about their exposed position. See Schatz, *Directors Feel the Legal Heat*, N.Y. Times, Dec. 15, 1985, at F12, col. 1; Rovner, *D & O Indemnity*, Legal Times, Nov. 25, 1985, at 1, col. 3.

47. Criminal liability has also been increasingly asserted against corporate officials for workplace safety, defective products, and environmental violations. For representative decisions, see *United States v. Park*, 421 U.S. 658 (1975); *United States v. Starr*, 535 F.2d 512 (9th Cir. 1976); *People v. Warner-Lambert Co.*, 51 N.Y.2d 295, 414 N.E.2d 660, 434 N.Y.S.2d 159 (1980), *cert. denied*, 450 U.S. 1031 (1981). For a survey of recent prosecutions of both individuals and corporations for defective products, see Goldfein, *Corporation Criminal Liability — Defective Products*, in *CORPORATE CRIMINAL LIABILITY* (O. Obermaier ed. 1986) (discussing prosecutions of officers of Eli Lilly & Co., Smithkline Beckman Corp., Film Recovery Systems Inc., and others); see also Low, *Taking Corporate Crime to Court*, INSIGHT, Sept. 15, 1986, at 52.

48. See R. BREALEY & S. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 123-26 (2d ed. 1984).

but still powerful in its impact. Generally, at the level of ordinary business decisions, the impact of this "risk aversion differential" will seldom be evident. In choosing among competing investment opportunities or business projects that do not threaten the firm's solvency, managers have little reason to act as if they were risk averse, because they are "repeat players" who understand that the firm, itself, is a diversified portfolio. However, when we move from the tactical to the strategic level, the conflict becomes pronounced. Some economists, such as Robin Marris and William Baumol,⁴⁹ have argued that corporate managers maximize sales or growth, not profits. In part, such an empire-building policy is pursued, they claim, to increase the security of the corporation's managers, because the acquisition of additional divisions and product lines both reduces the risk of insolvency and provides opportunities for personal advancement. Translated into the vocabulary of this paper, this claim can be understood as an assertion that managers seek to build a diversified portfolio within their firm. Exactly this specific claim has been made by financial economists, most notably by Amihud and Lev, who marshal evidence that "managers, as opposed to investors, . . . engage in conglomerate mergers to decrease their largely undiversifiable 'employment risk.'"⁵⁰ Where these different writers share a common ground is in their mutual recognition that empire building may be rational for managers but inefficient for shareholders.

This perception can be generalized to cover all investment decisions.⁵¹ In the area of corporate financial policy, there is again a close fit between this theory and empirical observations. In a well-known field study, Professor Gordon Donaldson of the Harvard Business School found that the corporations he studied as a participant-observer preferred to finance through retained earnings rather than

49. See, e.g., W. BAUMOL, *BUSINESS BEHAVIOR, VALUE AND GROWTH* (1959); R. MARRIS, *THE ECONOMIC THEORY OF "MANAGERIAL" CAPITALISM* (1964); see also notes 52-63 *infra*.

50. Amihud & Lev, *Risk Reduction As a Managerial Motive for Conglomerate Mergers*, 12 BELL J. ECON. 605, 605 (1981). The authors present empirical findings that conglomerate acquisitions are more likely to be made by management-controlled firms than by owner-controlled firms. See also Note, *The Conflict Between Managers and Shareholders in Diversifying Acquisitions: A Portfolio Theory Approach*, 88 YALE L.J. 1238, 1241-44 (1979).

51. See Marcus, *Risk Sharing and the Theory of the Firm*, 13 BELL J. ECON. 369, 373-75 (1982) (managers will generally prefer to pursue policies that are less risky than those that diversified shareholders would prefer and hence scale of investment with respect to any attractive investment will be suboptimal for shareholders if managers act in their own self-interest); see also Kihlstrom & Laffont, *A General Equilibrium Entrepreneurial Theory of Firm Formation Based on Risk Aversion*, 87 J. POL. ECON. 719 (1979) (different attitudes toward risk cause individuals to separate into workers and residual risk bearers). Unlike these authors, this article will argue that an equilibrium has not been achieved and substantial renegotiation of the "contract" is occurring within the large firm.

through the issuance of debt.⁵² Many firms that he interviewed plainly revealed a strong bias against any financing that involved resort to the capital markets. They required a considerably higher expected return from an investment before they would resort to external financing sources. In a more recent and extended study of a dozen mature industrial firms over the period of 1969 to 1978, Donaldson found that of the capital funds invested by these companies over that period, some 74% was internally generated, while 26% came from long-term debt, and none came from new equity issues.⁵³ What explained this aversion for the public capital markets? Donaldson concluded that the policy of these firms with respect to the use of debt could be "summed up in one word: conservatism."⁵⁴ In his view, managers treated their firm's debt capacity as if it were a hidden bank account to be saved for a rainy day. Leverage then is something that managers avoid, his study implies, because it consumes the firm's debt capacity, which they view as the buffer that protects them from the risk of future adverse events.

Other studies also point to this same conclusion that managers underutilize debt and avoid nonessential entanglements with the capital markets. One important finding has been that the rate of return experienced by public corporations on internally generated funds was well below that on debt or equity.⁵⁵ Indeed, for firms that did not resort at all to the equity market the return on "ploughbacked" funds has been

52. G. DONALDSON, *CORPORATE DEBT CAPACITY* 51-55 (1961). As a result, Donaldson found that some firms held to the rate of growth that they could finance internally without resort to the capital markets; other firms applied more stringent criteria to projects that would require outside finance, generally requiring a higher expected rate of return on such projects. Donaldson interpreted these findings to mean that managers sought autonomy from capital markets — a conclusion certainly consistent with the Baumol/Marris "managerial discretion" literature.

53. G. DONALDSON, *MANAGING CORPORATE WEALTH: THE OPERATION OF A COMPREHENSIVE FINANCIAL GOALS SYSTEM* 45-46 (1984).

54. *Id.* at 45. Donaldson writes:

In essence, the managers of these mature industrial companies sought to conduct their own affairs so that *they* could *always* borrow if necessary, even in bad times. They did so by keeping their borrowing within tight limits and by providing wide margins of safety over and above the lender's minimum lending rules. They made it a practice to live within the standards of an A credit rating at the least and within moderate debt/equity ratios. As a result, they were in a position to regard debt as an automatic extension of internally generated funds and to treat it, for planning purposes at least, as though it were an assured, off-balance sheet, liquid asset reserve.

Id. (emphasis in original).

55. The best known of these studies is Baumol, Heim, Malkiel & Quandt, *Earnings Retention, New Capital and the Growth of the Firm*, 52 *REV. ECON. & STATISTICS* 345 (1970). These authors examined the growth in earnings from 1946 to 1960 of the 900 firms on the Standard & Poors Compustat tape, using regression equations to differentiate earnings financed by "ploughback" (*i.e.*, earnings plus depreciation minus dividends) from earnings financed by debt and equity. For an excellent review and further analysis of these studies, see M. FOX, *FINANCE AND INDUSTRIAL PERFORMANCE IN A DYNAMIC ECONOMY: THEORY, PRACTICE AND POLICY* 233-37 (1987).

found to be near zero.⁵⁶ This startling finding suggests both that managers are overly biased toward earnings retention (possibly because they wish to maximize growth), and that they are reluctant to use the capital markets unless the projected investment offers a much higher rate of return than is ordinarily available to the firm. Even more to the point, other studies have found that management-controlled firms have a lower return on investment than firms where ownership and control is not separated,⁵⁷ and that management-controlled firms retain a higher percentage of earnings.⁵⁸

All this data comes into clearer focus once we begin from the premise that senior management, having a fixed investment in the firm, will act in a more risk-averse manner than the shareholders. In this view, managers tend to be reluctant to accept any form of capital market discipline, not just the discipline of the market for corporate control. Accordingly, a naive "growth maximization" model mis-specifies managerial incentives. Although the corporations that Donaldson studied doggedly pursued growth and enhanced market share (rather than the highest stock price or return on equity), they did so always within the constraint of seeking only that level of growth that could be "self-sustained" — that is, financed through internally generated funds and without utilizing the corporation's much-protected debt capacity. Such a portrait describes a management that is both risk averse and extremely protective of its own autonomy.

Excessive earnings retention is, of course, another facet of this same phenomenon, but one that directly relates to the motive for bust-up takeovers. Although managerialists have seen this behavior either as motivated by a desire for growth or as proof that managers have an "expense preference" that conflicts with the shareholders' interest,⁵⁹

56. After methodological criticisms were made of their original study, Baumol, Heim, Malkiel, and Quandt did a further study that segregated the return on "ploughback" from firms that avoided the capital markets from those that did issue debt or equity in these markets. This time, they found that firms that issued only negligible amounts of new equity had an average rate of return of near zero on their "ploughback." See Baumol, Heim, Malkiel & Quandt, *Efficiency of Corporate Investment: Reply*, 55 REV. ECON. & STATISTICS 128 (1973).

57. For a review of nine such studies, see W. MCEACHERN, *supra* note 43, at 39-50. McEachern's own findings were that management-controlled firms have a rate of return only half that of owner-managed firms and somewhat less than that of externally controlled firms.

58. Williamson, *Managerial Discretion and Business Behavior*, 53 AM. ECON. REV. 1032, 1047-51 (1963).

59. See *id.* Williamson found both high earnings retention ratios and a pattern under which declines in profitability brought sharp staff cutbacks without a decrease in production. This tendency for staff cuts to follow earnings declines, but not to precede them, was consistent with the "expense preference" that Williamson postulated — namely, that managers derive a positive utility from increasing staff and tend to minimize these expenditures only when the firm enters a period of earnings decline. In contrast, a profit-maximizing firm would always be seeking to minimize its costs.

the more fundamental cause-and-effect relationship may be the disparity in the level of risk aversion between managers and shareholders. Thus, the less risk-averse shareholder wants a high payout, while the manager wants to hoard cash and assets to protect against future contingencies. Of course, tax motives may also play a role here, because dividends are highly taxed; but if managers were simply conforming their behavior to the incentives that the tax laws held out, they would long ago have increased the firm's degree of leverage. Because they clearly have not, tax effects seem to have only a partial explanatory power.⁶⁰ In particular, tax incentives cannot explain the critical empirical finding that management-controlled firms are characterized by lower levels of systematic and unsystematic risk than owner-controlled firms⁶¹ — a finding that dovetails with the managerial risk-aversion hypothesis here expressed.

Finally, risk is also the critical element that may shape managerial compensation systems. A leading model of the labor market — known as the “implicit contract” model — assumes that employers are risk neutral, while employees are risk averse.⁶² Thus, the two sides negotiate employment contracts in which employees trade off some portion of the wages they could demand for employment stability. Because this model has the ability to explain both wage rigidity and underemployment equilibria, it has attracted considerable attention. To date, it has been chiefly used with respect to lower-level employees, but it applies at least as well to the manager, because the manager is even more dependent on the firm for his expected future wealth and may suffer a greater loss if forced to resort to the marketplace.⁶³ There is a profound irony here, because one tradition of neoclassical

60. If tax motives were the only or primary explanation, the picture should be a static one with no change in earnings retention ratios. Yet, during the late 1970s and early 1980s, Gordon Donaldson reports that a tension developed between corporate managements and investors, as the former sought to maintain low dividend payouts while investors began to express a stronger preference for “companies with high and sustained dividend yields.” G. DONALDSON, *supra* note 53, at 89. This is again an instance of the same “strain” that this paper submits is motivating the bust-up takeover.

61. See Amihud, Kamin & Ronen, “Managerialism,” “Ownerism” and Risk, 7 J. BANKING & FIN. 189 (1983). This study also found that management-controlled firms more frequently tried to “smooth” their income (that is, avoided sharp fluctuations). “Systematic risk” is the risk that remains after a portfolio is diversified, while “unsystematic risk” is in theory risk that can be diversified away.

62. See Azariadis, *Implicit Contracts and Underemployment Equilibria*, 83 J. POL. ECON. 1183 (1975); Azariadis & Stiglitz, *Implicit Contracts and Fixed Price Equilibria*, 98 Q.J. ECON. 1 (1983); Hall & Lilien, *Efficient Wage Bargains Under Uncertain Supply and Demand*, 69 AM. ECON. REV. 868 (1979); Rosen, *Implicit Contracts: A Survey*, 23 J. ECON. LIT. 1144 (1985).

63. This would be the case if the manager has invested in firm-specific human capital, see sources cited at notes 42-43 *supra* & 102-03 *infra*, or if the implicit contract deferred payments according to a seniority ladder.

economics has long argued that managers are undercompensated and so lack true entrepreneurial spirit.⁶⁴ The short answer to this thesis is that managers may have chosen fixed-wage contracts over more "entrepreneurial" variable-wage contracts precisely because they are risk averse.

One aspect of this system of implicit contracting is that it defers a considerable portion of the manager's expected aggregate compensation until the end of his career when he has climbed an elongated seniority ladder.⁶⁵ Such deferral may be in the shareholders' interest because it gives the manager an incentive to compete vigorously for advancement within the firm's internal labor market, but it also exposes the manager to a double risk. If there is a hostile change of control, the new owners can deny that they are bound by the prior implicit contract, and thus the manager can lose both the job security and deferred compensation for which he has forgone prior earnings. Such shareholder behavior can be seen as opportunistic, because one group of shareholders having struck a deal that traded security for reduced wages can maximize their returns by turning the firm over to those who need not fulfill this implicit promise.⁶⁶ In the past, managers had sought to enforce this promise by obtaining de facto control over the board, but in the new world of takeovers domination of the board is no longer an effective contractual protection.

Against this backdrop, the hostile takeover can be seen not simply as a mechanism that compels a management to accept that level of business risk that shareholders deem appropriate, but as a means by which shareholders outflank the safeguards managers obtained to protect the promises of deferred compensation and job security. Thus, what appears from the bidder's perspective to be a process of purging organizational slack looks from the manager's viewpoint more like deceptive reneging on the original understanding. In short, perspective matters, and our theory of the shareholder/manager relationship will largely determine our normative assessment of their respective entitlements.

64. Henry Manne in particular has claimed that existing systems of managerial compensation are inadequate to motivate managers and make them true entrepreneurs. See H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* 111-58 (1966). Professor Manne uses this argument to justify insider trading.

65. For a fuller expression of this theme, see Knoeber, *Golden Parachutes, Shark Repellents, and Hostile Tender Offers*, 76 AM. ECON. REV. 155, 159-61 (1986); cf. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. (Papers & Proceedings) 323 (1986) (noting tendency for firms to reward managers through promotion rather than year-to-year bonuses).

66. Knoeber, *supra* note 65, at 159-60.

B. *Theories of the Firm*

This section will analyze in order three groups of theories: (1) the Neoclassical Model (where writers such as Michael Jensen, Eugene Fama, Armen Alchian, and Harold Demsetz constitute the principal theorists⁶⁷); (2) the Managerialist Model (whose leading advocates include William Baumol, Robin Marris, Harvey Leibenstein, and Dennis Mueller⁶⁸); and (3) the Transaction Cost Model (whose leading proponent is Oliver Williamson⁶⁹). While these theories ultimately may be complementary or at least can be read to reinforce each other, it is useful to take each initially on its own terms.

1. *The Neoclassical Model*

The leading neoclassical model of the firm — that offered by Professors Jensen and Meckling — begins essentially where Berle and Means left off a half century ago.⁷⁰ Initially, they recognize the potential conflicts that arise between managers and shareholders once share ownership becomes dispersed; the utility-maximizing agent, they acknowledge, does not necessarily have an incentive to act in the best interests of his principal. Accordingly, the principal will have to incur costs to monitor the agent's performance and will pay less for shares in the corporation in proportion to the magnitude of the "agency costs" that must be so incurred. At this point, Jensen and Meckling make their distinctive contribution: It is in the agent's interest, they argue, to convince investors that the firm will have an institutional structure which will minimize agency costs (a term that includes both the expenditures incurred to reduce managerial misappropriation and shirking plus the irreducible minimum of such losses). That is, because agency costs reduce the market value of the firm, the agent as the firm's promoter will wish to minimize them. These agency costs can be reduced in a variety of ways: (1) through monitoring expenditures (such as the use of outside directors, audit committees, and independent directors); (2) through bonding devices (which will be discussed

67. See sources cited at note 28 *supra*.

68. See W. BAUMOL, *supra* note 49; R. MARRIS, *supra* note 49; Leibenstein, *Allocative Efficiency vs. "X-Efficiency,"* 56 AMER. ECON. REV. 392 (1966); FitzRoy & Mueller, *Cooperation and Conflict in Contractual Organizations*, 24 Q. REV. ECON. & BUS. 24 (1984); Marris & Mueller, *The Corporation, Competition, and the Invisible Hand*, 18 J. ECON. LIT. 32 (1980).

69. See O. WILLIAMSON, *supra* note 43; Williamson, *supra* note 39; Williamson, *supra* note 29.

70. Jensen and Meckling acknowledge that their model applies chiefly to the smaller, entrepreneurially managed firm. Jensen & Meckling, *supra* note 28, at 351-54. However, they speculate that the same principles apply to the larger public corporation analyzed by Berle and Means.

shortly); and (3) through incentive compensation that gives the agent a substantial equity investment in the firm and so a desire to maximize its share value. Following Jensen and Meckling, neoclassical economists have tended to assume that market forces alone will result in the installation of the optimal level of monitoring devices and incentive systems that bring agency costs down to an irreducible minimum. At this minimal level, no additional dollar spent on internal controls or incentive compensation will yield an equivalent reduction in managerial opportunism or shirking.

One could debate at length whether market forces alone are adequate to minimize agency costs or whether the law also has a positive role to play, but our focus is narrower: do these forces work to align the manager's risk-aversion level with those of the shareholders? It seems extremely doubtful that the contractual devices described by Jensen and Meckling do anything like this. Take, for example, the use of outside directors. If anything, they have reason to be even more risk averse than managers. This is because their economic stake in the corporation is relatively small while their potential personal liability may be significant once the corporation becomes financially distressed. Their own individual cost/benefit calculus should therefore make them resist a high-risk course of action, even if they were generally risk neutral, because for them the potential losses are likely to exceed the potential gains. In addition, outside directors are subject to severe cognitive limitations: the information they receive comes to them through management, and they have little independent means of verifying the set of opportunities the corporation has to choose among.⁷¹ Interestingly, business school academics have independently concluded that outside directors are inherently more likely to be a brake on, rather than a motor force for, organizational innovation or other change that would produce a higher risk level.⁷²

The other principal mechanism identified by Jensen and Meckling — incentive compensation through stock options — also seems limited in its impact. Absent a substantial equity interest in the firm, the manager is an "implicit debt holder," looking to a future stream of salary payments, and thus has an incentive to reduce his firm's stock volatility in order to make it less risky.⁷³ Although stock options more

71. For a discussion of these limits on the board as a monitoring body, see Coffee, *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099 (1977).

72. J. WORTHY & R. NEUSCHEL, *EMERGING ISSUES IN CORPORATE GOVERNANCE* 77-79 (1984).

73. See Note, *The Executive Compensation Contract: Creating Incentives to Reduce Agency Costs*, 37 STAN. L. REV. 1147, 1174 (1985) (arguing that this factor causes managers to over-

closely align the manager's self-interest with that of the firm's residual risk bearers (*i.e.*, the shareholders), the award of stock in the firm can only give the manager a more undiversified portfolio and so maintains a differential between his level of aversion to firm-specific risk and that of diversified shareholders.⁷⁴

Once we introduce the institution of the hostile takeover and postulate that at least some bidders view their targets as having operated in a bureaucratic, overly risk-averse and insufficiently entrepreneurial fashion (a description of bidders that at least fits the public prose of Carl Icahn and, to a lesser extent, Boone Pickens), then the takeover becomes comprehensible as a device that disciplines "excessive" risk aversion. Given its existence, managers may find it in their interest to turn to what can be described as a "bonding" device: they can increase corporate leverage as an *ex ante* takeover defense. As will be discussed below in Part I.C, this description seems to fit the financial restructuring that over the last two years has become the principal long-term takeover defense strategy of those firms who believe themselves to be potential targets.

Viewed in terms of the neoclassical model, the recent emphatic increase in corporate leverage as the result of debt issuances, stock repurchases, and high dividends can be viewed as a "bonding" device by which managements signal to the market that they will not maintain a conservative capital structure or hoard assets when diversified stockholders would prefer a high payout. Some commentators have suggested that a high dividend payout is a means of reducing agency costs by assuring investors that the firm will have to subject itself (and its policies) regularly to the discipline of the market in order to finance new projects.⁷⁵ Actually, this ingenious argument simply stands on its ear the earlier thesis of Berle and Means that the market had little disciplinary power over managers because managers relied on internal cash flow to finance expansion. Empirically, the difficulty that this claim faces is that few firms do seem to pay out such a high ratio of

invest in risk-reducing activities, such as diversifying acquisitions, and underinvest in projects that increase the firm's stock volatility, such as research and development expenditures).

74. It has been argued that optimal executive compensation packages employing a "relative market price standard" could be designed that would reduce this factor of risk aversion. Note, *supra* note 73, at 1168-76. Under this approach, the manager would be compensated based on his firm's success in the stock market relative to the stock performance of other similar firms. Still, even under such a novel system, the manager would have significant human capital at risk. Moreover, proponents of this approach are forced to acknowledge that executives do not desire to be compensated under this type of arrangement. *Id.* at 1175-76. Whenever an "optimal" solution appears to be broadly disfavored, one has to question whether it is truly optimal.

75. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650 (1984).

earnings as dividends as to compel them to resort to the capital markets;⁷⁶ in effect, the Berle and Means premise here remains substantially accurate.

A further variation has been advanced on this thesis. When debt is exchanged for stock (a now-frequent phenomenon in takeover defense tactics), one can say that this debt issuance represents a firmer promise than does a past dividend payout record that the corporation will not pursue growth over profitability. In other words, as Professor Jensen has argued, because interest payments are mandatory while dividends are only discretionary, leverage can be viewed as a tactic by which management makes a more credible promise to accept the market's judgment, because more frequent returns to the market will be necessary for a firm with a high debt/equity ratio.⁷⁷

A puzzling aspect of this thesis is that despite its theoretical plausibility, little empirical confirmation existed for it prior to the appearance of the bust-up takeover. That is, managers do not seem to have voluntarily adopted the suggested technique for "bonding" themselves to follow their principals' preferences. Only with the advent of the bust-up takeover is there any evidence that something is occurring that arguably resembles the kind of bonding that the Jensen and Meckling model predicts managers will engage in. But this takeover-induced bonding can hardly be called voluntary. This in turn suggests either that managers' aversion to risk is very strongly held or that the Jensen and Meckling model generally overestimates the willingness of managers to bond themselves in order to increase the firm's stock value.

2. *The Managerialist Model*

While the neoclassical model uses the market as its starting point, another variety of model begins with the manager. Rather than assume that the firm is externally controlled by the market, theorists

76. Professor Merritt Fox has calculated that dividends averaged 58% of after-tax profits during the decade of the 1970s. See M. FOX, *supra* note 55, at 443 n.95. Professor Fox based this calculation on figures in Table B-82 in THE ECONOMIC REPORT OF THE PRESIDENT, H.R. Doc. No. 140, at 315 (1984). Professor Fox further finds that "[c]urrently, internally generated funds are sufficient to finance about 90% of . . . [the] capital expenditures" incurred by the 500 largest industrial firms. M. FOX, *supra* note 55, at 385. Thus, if 90% of corporate investment can be financed internally, resort to the capital markets has apparently been minimized. For similar findings, see Baumol, Heim, Malkiel & Quandt, *supra* note 55 (finding very low rate of return on retained earnings, thus suggesting that managements have tended to retain earnings when they should pay dividends); G. DONALDSON, *supra* note 53, at 36-42 (finding that managers sought to maximize not profits but the assets and borrowing capacity under their control).

77. M. Jensen, The Takeover Controversy: Analysis and Evidence (paper prepared for Columbia Law School Conference on Takeovers and Contests for Corporate Control, Nov. 15, 1985).

have developed "internal" theories of the firm, in which the manager is the central actor.⁷⁸ In focusing on the manager, these theorists emphasize both the severe cognitive limitations that surround business decisionmaking and the opportunities for discretionary behavior by managers. Denied perfect information, the manager in the large organization exists in a world of "bounded rationality" in which he must search for satisfactory answers to immediate problems by adopting more or less trial-and-error strategies. As a result, the manager functions by seeking not optimal solutions but only satisfactory ones. As developed by Nobel laureate Herbert Simon and his colleagues, this "behavioral" theory of the firm postulates that managers do not profit-maximize, but rather "profit-satisfice" — that is, they seek that level of profits that will suffice to prevent external interventions by dissatisfied creditors or stockholders.⁷⁹ So viewed, managers are in effect semi-autonomous, subject only to the weak external constraint that the providers of the firm's capital must receive a minimal return.

How do managers exercise the vast discretion that this model sees them as possessing? In the best known of these models, Robin Marris sees managers as using those residual funds left over after external constraints were satisfied to expand the size of the firm.⁸⁰ Why is growth maximization the goal of managers? According to Marris, growth provides managers with greater compensation, greater psychic income, and greater security. A similar theme (but absent this emphasis on the personal security of the manager as a force for growth) appears in another well-known model of the manager's utility function developed by Oliver Williamson.⁸¹ Professor Williamson postulates that managers have an "expense preference"; they gain a personal utility from expenditures on increased staff or growth. Neither Marris nor Williamson places the problem of risk at center stage in their models, but in each case this idea is at least consistent with their analysis that managers use their discretion to reduce the insecurity to which they are subject. In this paper's vocabulary, their assertions translate into a claim that managers are seeking to reduce risks that do not appear to trouble the firm's shareholders. Much this same theme that

78. See sources cited at note 68 *supra*.

79. See H. SIMON, *MODELS OF MAN: SOCIAL AND RATIONAL* (1957); J. MARCH & H. SIMON, *ORGANIZATIONS* 47-50 (1958); R. CYERT & J. MARCH, *A BEHAVIORAL THEORY OF THE FIRM* 9-10 (1963); R. GORDON, *BUSINESS LEADERSHIP IN THE LARGE CORPORATION* (1961).

80. R. MARRIS, *supra* note 49; see also G. DONALDSON, *supra* note 53, at 11, 36-42 (discussing the "compulsion to grow" in the firms studied and postulating the manager's objective as "the maximization of corporate wealth (as distinct from shareholder wealth)").

81. See Williamson, *supra* note 58.

managers use their discretion to reduce their insecurity within the firm can also be found in the writings of the principal organization theorists.⁸² However phrased, the claim that managers want to pursue growth or other security-enhancing objectives within the boundaries established by external profit constraints on the firm is at least in part a statement that managers will seek to reduce risk up to that point where the shareholders may oust them if they pursue this objective further.

How valid do these managerialist theories seem today? Although they are intuitively attractive in their description of managerial objectives, they also have a dated quality in their implicit assumption that firms are large, unchanging bureaucracies and that the market constitutes only a weak external constraint. These models were developed in the early 1970s based on the experience of the late 1960s, when it was still possible to write confidently of corporations as unchanging bureaucratic organizations that were only weakly constrained by the market. In short, these models predate the emergence of the takeover as a major constraining force, the rise of active institutional investors, the appearance of foreign competition, and the traumatic series of shocks that the American economy began to experience in the 1970s.

Yet, if these theories understate the external constraints on the corporate manager, there is, if anything, additional reason today to believe that they correctly describe the manager's own preferences as biased in favor of growth over profitability. The best evidence of this bias lies in the recent prevalence of bust-up takeovers. Such takeovers are ones in which the asset value of the firm on liquidation clearly exceeds the price that a bidder would have to pay to acquire the firm's stock. The puzzling question about such takeovers has been why the firm's asset value is so much in excess of its stock market value. Based on the foregoing analysis, the most plausible answer is not that these firms were inefficient in the usual sense of substandard operating performance, but rather that they either had grown to an inefficient size or were failing to exploit opportunities to create value for their shareholders through increased leverage or a higher payout ratio.⁸³ This

82. V.A. Thompson and Herbert Simon in particular have emphasized this theme, which views large organizations as generating great anxiety and insecurity for their members. For a recent restatement of this theme, which views the middle-level manager as a virtual paranoid as a result of the political power struggles within large firms, see E. SHORRIS, *THE OPPRESSED MIDDLE: POLITICS OF MIDDLE MANAGEMENT* (1981).

83. Managerial preferences for growth over profit are not the only factor at work that has caused the disparity of asset and stock values. This factor interacted with the impact of record inflation during the decade of the 1970s. In an inflationary period, the market value of real assets increases, while the market value of financial assets declines. See *RESTRUCTURING FINANCIAL MARKETS*, *supra* note 13, at 373. To the extent that corporate managers pursued a policy of

answer also helps to explain the “deconglomeration” movement, which will be discussed shortly and which has involved a record level of spin-offs and sales of assets by large corporations under the threat of a takeover.

Ironically, this resolution implies that both sides in the debate between the neoclassical and managerial positions may be partially correct. That is, the takeover may in these instances be enhancing efficiency (at least to the extent that the market’s judgment can serve as a proxy for efficiency), but it is doing so largely because the manager had a preference for inefficient growth and earnings retention, as the managerialists hypothesized.

3. *The Transaction Cost Model*

The theory of the firm developed by Oliver Williamson is unique in that it builds upon a historical base, relying on the work of the business historian Alfred Chandler. Chandler found that American corporations underwent a major transition during the middle of this century, as a result of which a new form of corporate structure arose that was characterized by decentralized, semi-autonomous divisions coordinated by a central executive office.⁸⁴ Williamson has offered a plausible theory to explain this development by essentially returning to a central question posed by Ronald Coase: why are some business decisions coordinated by markets and others resolved by internal administrative decisions within the firm?⁸⁵ Williamson’s answer (also suggested by Coase in a more rudimentary form) is that the internal processes within the firm involve lower transaction costs than does the use of the market system.⁸⁶ In other words, the firm exists to effect those processes that it can coordinate more efficiently than the market.

In Williamson’s view, the modern conglomerate (or “M-Form Firm”) functions as a miniature capital market in which the central executive office reallocates funds from stagnant or low-growth divi-

“profit-satisficing,” retained corporate earnings inefficiently, and paid dividends in amounts determined by comparison to the return on debt securities, equity securities in such companies would resemble debt securities and would experience at least stagnant growth rates. Meanwhile, the value of real assets skyrocketed throughout the highly inflationary 1970s, thus producing the current disparity that can justify takeover premiums on occasion of 100% or more.

84. A. CHANDLER, *supra* note 30.

85. Coase, *The Nature of the Firm*, 4 *ECONOMICA* (n.s.) 386 (1937), reprinted in R. POSNER & K. SCOTT, *ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION* 3 (1980).

86. Originally, Williamson’s work primarily stressed the historical side of his story, relying on Chandler and arguing that the M-Form Firm had superior monitoring properties. More recently, he has stressed the theme of asset specificity as his starting point. See Williamson, *supra* note 39, at 1548-49. To the extent that asset specificity is present, he maintains that firms can outperform markets at reducing the transaction costs associated with recurring transactions.

sions to high-growth winners in a manner that out-performs the capital market. Because of its superior monitoring ability, the M-Form Firm gradually superseded its predecessor, the U-Form Firm, which had a functionally specialized management but did not have the same multi-unit, diversified scope of operations or the decentralized system of administration that developed within the M-Form Firm.⁸⁷

Yet, it is precisely with respect to this claim of superior efficiency for the M-Form Firm that recent developments in corporate structure present a problem. Indeed, these developments suggest that the Williamsonian theory may be historically bounded as well as historically derived. Put simply, if the conglomerate form is more efficient than the earlier U-Form Firm, why has there been a sudden trend toward "deconglomeration"? The specifics of this trend will be noted in the next section, but the more important issue involves identifying the motor force driving it. To say that the deconglomeration movement is takeover-induced (as it clearly is) begs the question. Why is it takeover induced? What inefficiency does the market see in the conglomerate form and why has this trend toward deconglomeration suddenly peaked two decades after the full-scale appearance of the modern conglomerate in the 1960s?

One possibility is, of course, that the managerialists could be more right than Professor Williamson. That is, the growth of the conglomerate could owe more to the growth-maximizing preferences of managers, who are seeking to build a diversified portfolio within a single firm, than to its greater efficiency as Professor Williamson postulates. A more balanced interpretation might be that the advent of the M-Form Firm facilitated corporate growth, including inefficient growth, because it permitted a large volume of economic activity to be coordinated within a single firm; the earlier U-Form Firm simply could not handle the scale of activity coordinated within the M-Form Firm, and thus it placed an implicit upper boundary on the ability of its manag-

87. For Professor Williamson's fullest statement of the superior monitoring and control properties of the multidivisional (or M-Form) firm, see O. WILLIAMSON, *supra* note 43, at 132-75; Williamson, *supra* note 39, at 1555. For Professor Chandler's description of the decline of the earlier unitary (or U-Form) structure, which became operationally overloaded by the number of complex "problems of coordination, appraisal, and policy formulation" forced to the top under its structure, see A. CHANDLER, *STRATEGY AND STRUCTURE: CHAPTERS IN THE HISTORY OF THE INDUSTRIAL ENTERPRISE* 382-83 (1962). In the multidivisional firm, operational decisions were coordinated at a lower level within the corporate hierarchy, thus freeing senior management to focus on strategic planning. Others have also argued that the M-Form Firm has the advantage of holding a diversified portfolio, but Professor Williamson has himself expressed skepticism about this diversification advantage. See Williamson, *supra* note 39, at 1558. His stress has been on the ability of the M-Form Firm to reallocate earnings within its divisions more efficiently. See O. WILLIAMSON, *supra* note 43, at 147 (cash flows in M-Form Firm "are not automatically returned to their sources" but are exposed to internal competition for funds).

ers to pursue growth. Still, some evidence has shown that diversification at the shareholder level has outperformed conglomerate firms.⁸⁸ This is hardly the result one would expect if the modern conglomerate had superior monitoring ability. In addition, the work of Dennis Mueller and others casts doubt on whether the conglomerate firm has achieved greater efficiencies.⁸⁹

Even if the Williamsonian firm does have efficiency-enhancing properties, another possibility is that the tendency toward inefficient expansion could be sufficiently prevalent to create a cloud over the use of the conglomerate form. Investors may find it difficult to distinguish these "pseudo M-Form Firms" that have grown to inefficient size or that intend to "hoard" earnings when shareholders would prefer a higher dividend payout from those in which use of the M-Form has achieved an efficient reallocation of funds at lower transaction costs. Such judgments involve uncertain predictions of the future, during periods when the corporation may be under a different management team, and thus are highly speculative. In short, if investors cannot distinguish "good" from "bad" conglomerates (in terms of their likely future behavior), a "market for lemons" effect could arise along the lines suggested by Professor Akerlof.⁹⁰ That is, even if only a minority of all conglomerates exhibited the behavior predicted by the managerialists, the market might still penalize the stock prices of all conglomerates by an average discount factor because monitoring by investors could not easily distinguish between these firms. As a result, arbitrage profits would still be available to bidders seeking to realize the difference between the stock market price and the asset value on all conglomerates.

88. See Mason & Goudzwaard, *Performance of Conglomerate Firms: A Portfolio Approach*, 31 J. FIN. 39 (1976) (finding that a randomly selected diversified portfolio of securities outperformed conglomerate firms); see also Melicher & Rush, *The Performance of Conglomerate Firms: Recent Risk and Return Experience*, 28 J. FIN. 381 (1973); Weston & Mansinghka, *Tests of the Efficiency Performance of Conglomerate Firms*, 26 J. FIN. 919 (1971). Thus, although the M-Form Firm may outperform its predecessors at the firm level, it is not clear that the shareholder could not do as well at lower cost by himself.

89. For an overview of the evidence that conglomerate acquisitions have not increased efficiency, see Mueller, *The Case Against Conglomerate Mergers*, in THE CONGLOMERATE CORPORATION 71, 76-89 (R. Blair & R. Lanzillotti eds. 1981); see also Mueller, *The United States, 1962-1972*, in THE DETERMINANTS AND EFFECTS OF MERGERS: AN INTERNATIONAL COMPARISON 271, 283-97 (D. Mueller ed. 1980).

90. There is a well-known economic argument that when consumers (or investors) cannot distinguish the quality of a particular product they will discount all similar products by the same average factor that reflects their skepticism over quality. See Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanisms*, 84 Q.J. ECON. 488 (1970). The force of the argument in this context arises from the fact that investors cannot ordinarily assure themselves that managements will not in the future pursue growth-maximizing or excessively risk-averse policies, because the future is inherently uncertain. Hence, investors may apply an average agency cost discount to all conglomerate stocks.

More generally, the behavior of bidders strongly suggests that they see the conglomerate firm as overstaffed and excessively diversified. Carl Icahn, Sir James Goldsmith, and Robert Tisch have all sounded this theme, and even the Reagan Administration has echoed it.⁹¹ This apparent consensus suggests that the Williamsonian thesis underestimates the potential for excessive staff layering to develop with the multi-divisional firm, whose managers, unlike their counterparts in single-industry firms, can more easily justify expanded staffs and who have a self-interest in establishing a system of automatic promotions and a multi-tiered hierarchy. To say this is not to deny that the monitoring staff at the apex of this M-Form Firm is effective, but the problem of "who will monitor the monitor" remains in all organizational structures. Absent a disciplinary force external to the firm, there is little in the structure of the M-Form Firm that precludes excessive firm investment in monitoring staff and much that invites it.

Finally, the Williamsonian model gives little attention to the rise over the last twenty years of two external monitoring forces: the institutional investor and the takeover bidder. Inherently, any improvement in external monitoring controls reduces the significance of the disparity between the internal monitoring capacity of the M-Form Firm and its predecessor, the U-Form Firm. As a result, the comparative advantage of the M-Form is reduced. In addition, the institutional investor is inclined to view the diversification advantages of the conglomerate as dubious, for two quite different reasons. First, because the institutional investor is already the holder of a diversified portfolio, it has little need to invest in another diversified portfolio, which is what the large conglomerate essentially resembles. Rather, the institutional investor's need is to pick and choose stocks to fill specific holes in its own portfolio.⁹² Almost by definition, a diversified conglomerate does not have such a specific profile that can match this need. Thus, the institutional investor has reason to disdain it or to

91. Richard Darman, Deputy Secretary of the Treasury, has recently popularized the term "corpocracy" to refer to large corporations that he sees as "bloated, risk-averse, inefficient and unimaginative." See Kilborn, *Treasury Official Assails "Inefficient" Big Business*, N.Y. Times, Nov. 8, 1986, at 1, col. 4. Similar rhetoric has long been used by the leading financial entrepreneurs who undertake bust-up takeovers. Moreover, their postacquisition behavior has been entirely consistent with their public statements, as they have in fact radically pruned staff size and reduced diversification. For a representative example, see Greenhouse, *Prelude to CBS: Tisch at CNA*, N.Y. Times, Nov. 28, 1986, at D1, col. 3 (discussing cost-cutting by Lawrence Tisch after takeovers and moves to reduce diversification).

92. Portfolio revision is a constant process. Exogenous changes — mergers, bankruptcies, changes in the business strategy or environment of firms — are always occurring. Hence, even a money manager who is content with his portfolio will find from time to time that an exogenous change has caused it to become less well diversified and thus requires him to engage in stock trading.

purchase its stock only at a discount. To the extent that a bias against diversification prevails in the market,⁹³ there may again be a market penalty imposed on the use of the conglomerate form. Second, the institutional money manager has a self-interest that disinclines him toward investing in diversified conglomerates. Investing in a portfolio of conglomerates is little different from investing in a market index fund. From the standpoint of the money manager, it becomes difficult to justify high management fees for transactions that are so easily and costlessly effected.⁹⁴ Hence, self-interest — whether conscious or unconscious — dictates that these managers maintain that they can outperform this simple strategy of diversification by selecting less diversified companies.⁹⁵

4. *A Summary — And Some Counterarguments*

The responses of these three models differ significantly in their recognition and treatment of the asymmetry in risk attitudes between managers and shareholders. The neoclassical model does not deny that managers may be more risk averse, but argues that increasing corporate leverage represents a form of bonding by which managers are compelled to accept their shareholders' preferences. Yet, if this is bonding, it is curious why it is happening only today. The abrupt character of this transition suggests that managers had declined to adopt their shareholders' preferences with respect to the issues of risk, growth, and the optimal payout of earnings, until the takeover forced them to do so. If so, the theory of bonding seems weak, and it is only the takeover that has compelled change. Conversely, the managerialist model can easily accommodate the idea of a disparity in risk aversion between managers and shareholders, but it seems historically dated in its failure to recognize the impact of the takeover on the balance of power between shareholders and managers. It assumes that takeovers, like mergers generally, only produce more growth and more empire-building. The irony is that the takeover may be the one mechanism that can purge organizational slack from these corporate em-

93. It is now common to find popular financial columns in which a major corporation is described as "still too diversified." See Pollack, *Market Place: Streamlining Transamerica*, N.Y. Times, Aug. 14, 1986, at D3, col. 1 (describing Transamerica Corporation as still too "un-focused" despite its disposition of Budget Rent-a-Car Corporation). In effect, such commentary shows a stock market bias against diversification at the firm level.

94. This argument is closely related to the much-discussed topic of whether too much is paid for securities research. See Langbein & Posner, *Market Funds and Trust Investment Law*, 1976 AM. B. FOUND. RES. J. 1; Pozen, *Money Managers and Securities Research*, 51 N.Y.U. L. REV. 923 (1976).

95. They may, of course, be right in this belief. See sources cited at note 88 *supra*.

pires, albeit at a potentially disturbing social cost. Finally, the transaction cost model seems simply to ignore the problem of risk.

Counterarguments can, of course, be raised to this article's assertion that a risk-aversion differential is a central strain within the modern public corporation that explains much recent takeover activity. In particular, Professor Michael Jensen's recent "free cash flow" theory essentially merges important aspects of neoclassical agency theory with the managerialists' recognition that there exist excessive incentives for firm growth.⁹⁶ In Jensen's view, takeovers are producing a new organizational innovation — a firm that creates a higher level of debt in order to "bond" the promise of its managers not to retain earnings inefficiently. Higher debt levels imply according to this interpretation that managers are substituting for the "weak" and legally largely unenforceable promise to pay dividends a "stronger," legally enforceable promise to pay interest on securities that are essentially equivalent in terms of their level of subordination. In short, security holders recognize that management wants to hoard assets and retain earnings, and so they prefer the promise to pay interest, which they can enforce. Still, one can question the permanency of this innovation and whether agency costs will be reduced for long, because the intent of the parties structuring a leveraged buyout is generally to take the company public again within a relatively brief time.⁹⁷ In contrast, this article's view is that the threat of a takeover is forcing managers to overinvest temporarily in their firm by taking it private in a leveraged buyout; but the costs of holding such an expensive and undiversified investment predictably make this a short-term investment and lead the managers either to reduce the degree of leverage by selling assets or to issue new equity securities, once the takeover threat has subsided.⁹⁸ In

96. See Jensen, *supra* note 65.

97. It has been reported that the investment banking firms participating in buyouts "expect to maintain their equity investments in these buyouts for short periods, generally no longer than five years, then cash in by selling the company to another buyer, or reoffering its shares to the public." See Sterngold, *supra* note 4, at D5. A classic example of this pattern, well known to investment bankers, involved Gibson Greeting Cards, which was taken private in a leveraged buyout in 1982 and then resold in a public offering in 1983 at an astounding \$200 million profit for its investment bankers, who made only a minimal investment of \$1 million. See Arenson, *How Wall Street Bred an Ivan Boesky*, N.Y. Times, Nov. 23, 1986, at F1, F8.

98. This has certainly been the pattern in the extreme examples of Unocal Corp. and Phillips Petroleum Co. Following its successful leveraged defense against both Boone Pickens and later Carl Icahn, Phillips has subsequently sold \$1.7 billion in assets and reduced its debt from \$8.6 billion to near \$6 billion. See Rose & Blumental, *Heavy Debts Weigh on Unocal, Phillips*, Wall St. J., July 28, 1986, at 6, col. 1. More recently, Union Carbide Corporation has begun to repurchase the \$2.5 billion in debt it issued to defeat GAF's hostile tender offer for it. To finance these repurchases, it will issue common stock and sell assets. See *Carbide to Buy Back Billions in Debt*, N.Y. Times, Dec. 1, 1986, at D1, col. 3. Here again, the experiment with high leverage lasted only a year before management began to reverse it.

short, although Jensen's emphasis on the managerial incentive to hoard "free cash flow" is correct, the bonding process that he believes will cure this problem has yet to show durability. Once the momentary threat has passed, the same agency-cost problems will return when new shares are issued, making the process more circular than permanent. Such a pattern of a short-term return to the market would suggest that a risk-aversion differential is an enduring feature of the public corporation, even if this cyclical pattern may subject the corporation to greater external monitoring on its return to the public market.

While the factor of risk is downplayed by Jensen, it is explicitly rejected by Professor Williamson, who argues that both shareholders and managers should be modeled as if they were risk neutral.⁹⁹ Although this position enables him to sidestep the related claim that the modern conglomerate arose, not simply because it was a more efficient monitor, but because conglomerate acquisitions allowed risk-averse managers to diversify away the firm-specific risk to which they were otherwise subject,¹⁰⁰ its logic works only if some debatable empirical premises are accepted. Recognizing that a conflict does exist between the interests of shareholders and managers, Williamson interprets seemingly risk-averse managerial behavior as an attempt to secure protection for the manager's substantial investment of firm-specific human capital. Once one assumes that managers have a substantial investment of firm-specific human capital, it follows that they will be exposed to a loss of this capital if deprived of their position and compelled to resort to the market for executive services. Under his "hazard exposure" hypothesis, managers may still have an incentive to underleverage or avoid corporate investments that increase stock volatility, but it will be because of the vulnerability of their investment in human capital.¹⁰¹

99. See O. Williamson, *Shareholders and Managers: A Risk-Neutral Perspective* (Jan. 1986) (unpublished manuscript) (copy on file at *Michigan Law Review*).

100. See Amihud & Lev, *supra* note 50; see also, Note, *supra* note 50.

101. In the wake of the new "hazard" that the takeover represents for job security, Professor Williamson predicts that "management . . . will ask that its contract be renegotiated." O. Williamson, *supra* note 99, at 15. He concludes that this process of "re-equilibration" could result in one of several outcomes: (1) a higher risk premium for managers; (2) a more delimited job assignment; or (3) "protection against displacement," through contractual devices such as the "golden parachute." While he acknowledges that "[o]nce a takeover threat has materialized, [managers] may be unable to renegotiate their contracts to reflect the new hazard," he assumes confidently that "successor generations of managers will presumably be alerted and will contract accordingly." *Id.* at 21. Here, we disagree. Although I also see the problem as one of transition policy, I do not share Williamson's confidence that contractual remedies will "be developed in a discriminating way to reflect the particulars of the situation." *Id.* Contracting is after all costly, and many doubt that contractual provisions drafted on an ex ante basis can be adequately specific to cover all or even most contingencies or to relate sensibly the amount of compensation prom-

Thus, Williamson reaches a similar end result to that of this author, but he does so without recognizing a risk-aversion differential between shareholders and managers. The issue is thus joined: Do we need the "risk-aversion differential" to model recent developments within the firm? This article's answer is that the "hazard exposure" hypothesis largely assumes what is to be proved and can capture and explain only a modest proportion of the managerial behavior that the "risk-aversion differential" more fully explains. Three distinct reasons support this conclusion.

First, it is questionable as a general proposition whether managers have the level of firm-specific human capital invested in their firms necessary to make Williamson's theory a generalized explanation. To begin with, an active market for senior executive services exists, and many CEOs came to their present firm without prior service there.¹⁰² To be sure, internal promotion is the more common route, but the existence of a substantial rate of interfirm transfers is inconsistent with the claim that an executive must make substantial investments in firm-specific human capital to advance within the corporate hierarchy. Other barriers to lateral mobility — such as the lesser uncertainty associated with internal promotion and the forfeiture provisions in stock options and most pensions — better explain why lateral transfers are not more common. The tremendous success of executive recruiting firms (or "head hunters") also shows that managerial talent is not logically firm-specific. Indeed, the modern business school curriculum is

ised to the amount that would have been paid on an ex post settling-up basis. See Knoeber, *supra* note 65, at 157-61. Moreover, if managers simply are paid a risk premium, there is no disincentive against lateral transfer (which the promise of deferred compensation uniquely provides). Hence, a perverse incentive arises to "take the money and run." In any event, one sees few instances in practice of employment severance agreements being broadly conferred on middle management generally, thus suggesting that labor markets are not yet reequilibrating smoothly.

102. A 1981 study by *Forbes* magazine found that 121 out of 888 CEOs had become chief executives at their present firm without prior service at the firm. See *How Much Does the Boss Make?* *FORBES*, June 8, 1981, at 114. This seems a high rate, given the inherent advantages that other executives already at those firms would have in the competition to succeed the former CEO. Another survey found that lateral transfers account for 13% of changes in senior management. See Roche, *Compensation and the Mobile Executive*, *HARV. BUS. REV.*, Nov.-Dec. 1975, at 53. Robert Reich has collected data showing that each year 15% to 25% of all American executives leave their jobs and that at any given time 30% of American managers are seeking new employment. R. REICH, *supra* note 25, at 161. Another revealing piece of evidence as to the rate of lateral transfers is the current boom in executive recruiting firms. See Fowler, *Careers: Recruiting Business is Booming*, *N.Y. Times*, Oct. 21, 1986, at D9, col. 1 (reporting increases of 32% or more this year at some firms and finding its cause to be that "mobility among managers is rising"). To be sure, most executives are promoted from within, and the executive labor market is still largely an internal one. See note 43 *supra*. However, this rate of external mobility suggests that it is not necessary for an executive to invest in firm-specific capital to rise to even the CEO level. The preference for internal promotion and seniority ladders may again reflect an aspect of the "implicit contract" that risk-averse managers choose and does not demonstrate the pervasiveness of firm-specific human capital.

premised on the proposition that a broad range of executive skills can be taught that have career-long utility and wide applicability. Not only is executive mobility *among firms* increasing, but the typical career path of the young executive *within the firm* will today require that he transfer among the often unrelated divisions of a diversified conglomerate. Thus, the road to executive success requires that the executive learn "general purpose" executive skills, not simply "special purpose" (but dead-end) technological expertise.¹⁰³ In short, Williamson's emphasis on firm-specific human capital, although it certainly captures a piece of the problem, applies more to the lower-level technocrat — the engineer or manufacturing specialist — than to the financial executives who have increasingly come to dominate the upper ranks of management in corporate America.¹⁰⁴ An illustration of this point comes when we look at the profiles of the CEOs of recent target companies. While some undoubtedly have had substantial firm-specific capital invested in their firm, this characterization simply cannot be applied sensibly to executives such as Agee of Bendix, Bergerac of Revlon, Dingman of Signal, Wyman (formerly) of CBS, or other highly mobile chief executives, such as those at Esmark and Beatrice.

Given the broad employment experience and fungible talents of these executives, why should they behave as if risk averse? Here, we come to the second basic divergence between the two theories: even executives who lack firm-specific human capital still may be financially overinvested in their firm. It is in the firm's interest to compensate the manager through forfeitable stock options, unvested pension rights, and other forms of explicit and implicit deferred compensation in such a manner as to restrict the executive's lateral mobility (hence, the term "golden handcuffs" for managerial compensation packages). But as the firm succeeds in making the executive less mobile, it also makes him more risk averse.

Finally, there is a more general methodological objection to Williamson's reliance on firm-specific human capital: namely, postulating

103. A similar point has been made by Martin Weitzman, who also argues that labor as a factor of production is unique because it is more redeployable than capital. See M. WEITZMAN, *THE SHARE ECONOMY: CONQUERING STAGFLATION* 28-29 (1984). Williamson has disputed this characterization. See Williamson, *A Microanalytic Assessment of "The Share Economy"* (Book Review), 95 YALE L.J. 627, 631-32 (1986). As discussed, Williamson's arguments about "asset specificity" seem overstated when applied generally to human capital, given the increasing rate of executive mobility.

104. Indeed, Professors Hayes and Abernathy of the Harvard Business School decry the fact that the senior executive layers of corporate America are now largely populated by executives with either a financial or legal background, but little manufacturing experience. See Hayes & Abernathy, *Managing Our Way to Economic Decline*, HARV. BUS. REV., July-Aug. 1980, at 67. Still, whether for good or ill, this trend is visible to most.

its existence in substantial amounts requires a leap of faith. If the market places a lower value on an executive's services than does his current firm, one cannot automatically explain this disparity as attributable to the executive's unique value to his current firm. Sometimes this may be true, but a simpler explanation may be that the executive is overpaid because of high agency costs. Alternatively, a subtler explanation is that this executive earlier entered into an "implicit contract" with the firm under which it was expected that high, deferred returns were to be paid on the basis of seniority.¹⁰⁵

In the last analysis, both the "risk-aversion differential" and the "hazard exposure hypothesis" can coexist as complementary theories. Each explains a piece of the puzzle. Although this article agrees that firm-specific human capital is exposed to loss by the takeover, that account is incomplete, and the factor of risk aversion cannot be omitted. Almost certainly, only risk aversion can explain the behavior of directors, who face real liabilities but have little firm-specific human capital invested in their positions.¹⁰⁶ More generally, the risk-aversion differential has the greater explanatory power, because it can help account for other forms of behavior — such as seniority ladders, excess staffing, the avoidance of corporate investments having high volatility (such as those on research and development), and the failure of managers to make greater use of debt or the capital markets — which the "hazard exposure" hypothesis largely leaves unexplained.¹⁰⁷

C. *The Empirical Evidence*

Most attempts at empirical evaluation of the takeover phenomenon have sought to study either targets or bidders, typically through stock price studies or follow-up studies of their postacquisition performance.¹⁰⁸ This seems the wrong focus, or at least an overly narrow

105. This would be consistent with the premise of managerial risk aversion, since it would reduce uncertainty.

106. That directors behave in a risk-averse manner seems plainly obvious at a time when many outside directors are fleeing the board as a result of the decreased availability (or higher cost) of "D&O" liability insurance. See *Business Struggles to Adapt As Insurance Crisis Spreads*, Wall St. J., Jan. 21, 1986, at 31, col. 1; Lewin, *Director Insurance Drying Up*, N.Y. Times, Mar. 7, 1986, at D1, col. 3.

107. If we assume that middle managers are risk averse, then both shareholders and such managers would logically prefer a compensation system that granted them regular promotions with relatively small increments in pay, over a system that granted them year-to-year bonuses that fully reflected the marginal revenues generated by the employee. Risk-neutral shareholders should also prefer such a system because it would be to their advantage to exchange certainty for a salary discount. Over time, however, this system would create a "strong organizational bias toward growth to supply the new positions that such promotion-based reward systems require." See Jensen, *supra* note 65, at 323 (citation omitted). In this way, risk aversion can be related to growth and excess staffing.

108. The literature on stock price studies is endless. For an overview, see Jensen & Ruback,

one, because the more important impact of the takeover may well be on those firms and managers who are not taken over, but who change their behavior as a result of the general deterrent threat of a takeover. In principle, this deterrent impact dwarfs the takeover's specific impact on those firms that are actually taken over, if only because this former category is vastly larger than the much smaller number of firms actually taken over. As will next be seen, the landscape of corporate America has changed radically since even 1980, and these changes — whether for good or ill — seem largely takeover-related.

1. *The Trend Toward Leverage*

Federal Reserve Board data show that the ratio of debt to equity of American corporations in 1962, as measured by the book value of assets less the face value of liabilities, was 58.2%. As Exhibit A¹⁰⁹ shows, this debt level as a percentage of book value grew gradually over the next 22 years until it reached 73% in 1983, never increasing as much as 5% in any one year. Then, in 1984, it rose from 73% to 81.4%, a jump that exceeded the entire prior increase from 1968 to 1983. This trend has clearly continued into 1986. Particularly alarming is the fact that short-term debt stood at a record 52% of total debt at the end of the first quarter of 1985, thus leaving companies more vulnerable than in the past to any increase in interest rates.¹¹⁰

The Market for Corporate Control, 11 J. FIN. ECON. 5 (1983). But see Malatesta, *The Wealth Effect of Merger Activity and the Objective Functions of Merging Firms*, 11 J. FIN. ECON. 155 (1983). Longer-term studies of the stock price and earnings performance of acquiring firms have only recently been conducted, and they give a far less optimistic picture of the wealth effects of merger and takeover activity. See E. Magenheimer & D. Mueller, On Measuring the Effect of Acquisitions on Acquiring Firm Shareholders (paper prepared for Columbia Law School Conference on Takeovers and Contests for Corporate Control, Nov. 15, 1985); E. Herman & L. Lowenstein, The Efficiency Effects of Hostile Takeovers: An Empirical Study (paper prepared for Columbia Law School Conference on Takeovers and Contests for Corporate Control, Nov. 15, 1985).

109. Exhibit A is a composite of data published by the Federal Reserve Board and is taken from an April 21, 1986, memorandum distributed by then-Representative Timothy Wirth, Chairman of the House Subcommittee on Telecommunications, Consumer Protection, and Finance of the Committee on Energy and Commerce (copy on file at *Michigan Law Review*). Exhibit A sets forth data for all nonfinancial corporations. If we restrict our focus to the Fortune 500 industrial companies, a 1984 survey found that total liabilities as a percentage of the book value of assets rose from 35% in 1960 to 55% at the end of 1984. See Labich, *Is Business Taking On Too Much Debt?*, FORTUNE, July 22, 1985, at 82, 82.

110. See Labich, *supra* note 109, at 82. In 1983 and 1984, short-term borrowing by nonfinancial corporations accounted for 62% of their total external financing. This contrasts with about a 35% share during the 1970s. See Henry Kaufman, Dangers in the Rapid Growth of Debt — The Need for a National Policy Response, at 3 (speech before the National Press Club, Jan. 1985, reprinted by Salomon Brothers, Inc.). Mr. Kaufman is Chief Economist at Salomon Brothers, Inc.

EXHIBIT A
DEBT-TO-EQUITY RATIOS: NONFINANCIAL
CORPORATIONS (PERCENT)

Year	Book Value ^a	Current Value ^b	Market Value ^c
1962	58.2	37.6	42.4
1964	59.9	41.8	37.7
1966	62.7	45.7	43.4
1968	67.2	49.4	35.6
1970	70.5	50.8	48.0
1971	70.4	51.2	46.7
1972	70.2	51.0	45.4
1973	70.9	49.7	61.9
1974	70.2	44.6	91.1
1975	66.7	42.3	72.0
1976	65.6	42.1	72.9
1977	67.7	41.4	84.0
1978	69.1	41.1	87.5
1979	69.9	39.9	79.0
1980	68.3	38.2	60.4
1981	71.0	38.9	70.2
1982	74.3	40.6	71.5
1983	73.0	40.9	63.4
1984	81.4	46.5	75.0
1985*	n/a	49.4	72.9

^a Debt is valued at par, equity is valued at book.

^b Debt is valued at par, and equity is balance sheet net worth with tangible assets valued at replacement cost.

^c The market value of debt is an estimate based on par value and ratios of market to par values of NYSE bonds; equity value is based on market prices of outstanding shares.

* Estimated values.

What caused this sudden leap? Part of the answer lies in the fact that 1984 was a year of high merger and takeover activity. According to Federal Reserve data, 1984 witnessed a record \$85 billion shrinkage in equity, which was the amount of net stock redemptions in 1984.¹¹¹ According to a New York Stock Exchange study, this shrinkage was a direct result of merger activity, as between \$84 billion and \$100 billion worth of equity was retired in merger exchanges of debt and cash for equity in 1984.¹¹² When the \$12 billion in new equity issued in 1984 is subtracted from these figures, the result is a merger-related decline of

111. Straszheim, *Are Corporations Overextended?*, MERRILL LYNCH BUS. OUTLOOK: WEEKLY ECON. & FIN. COMMENTARY, Aug. 5, 1985, at 1. Others place the figure even higher. See Saul, *Hostile Takeovers: What Should Be Done?*, HARV. BUS. REV., Sept.-Oct. 1985, at 18, 22 (placing figure at \$90 billion in 1984 or 4.5% of the total equity outstanding).

112. See Silk, *Economic Scene: Preventing Debt Disaster*, N.Y. TIMES, Sept. 6, 1985, at D2, col. 1.

at least \$72 billion. Prior to 1985, only a relatively small portion of this equity shrinkage could be directly attributed to the appearance of the junk bond,¹¹³ but much of the balance may be indirectly attributable to takeovers, as share repurchases, which are a principal cause of the equity shrinkage, have become a favorite takeover defense. Unquestionably, target corporations have found it an effective postbid defensive tactic to increase their leverage, in large part because doing so disrupts the junk bond financing that the bidder has typically assembled. Martin Marietta, Phillips Petroleum, Unocal, CBS, Union Carbide, and Revlon all used this same basic takeover defense: leveraging up and distributing the proceeds to shareholders.¹¹⁴

More common than the postbid self-tender as a last ditch defensive tactic is the use of share repurchases as an anticipatory defense that is undertaken by a corporation that realizes it is becoming a potential target. Increasing leverage and distributing the proceeds to its shareholders achieves a strategic advantage for such a target: the bidder who covets the target because of its unused borrowing capacity will realize that this objective has been frustrated and will instead seek a different target. Leveraging thus immunizes the target from a bootstrap acquisition in which a typically smaller bidder borrows against

113. According to the CONGRESSIONAL RESEARCH SERVICE REPORT, *supra* note 5, at 26, junk bond financing amounted to only 1.4% of all merger activity. See also Nash, "Junk Bond" Role Called Small in 1984 Mergers, N.Y. Times, Jan. 4, 1986, at 33, col. 1. Yet, the small relative size of junk bonds should not lead to a conclusion that their importance can be dismissed. The use of these bonds as a source of takeover financing began in 1983, grew significantly in 1984, and skyrocketed in 1985. See *Junk Bond Financing Up*, N.Y. Times, June 20, 1986, at D5, col. 6 (reporting that junk bonds accounted for 13.6% of takeover financing in the first half of 1985). The SEC's "Junk Bond Study" reported that in 1985 junk bonds accounted for 25% of the aggregate financing in hostile tender offers and 33% of the financing in the 30 largest tender offers. See SEC, *Noninvestment Grade Debt*, *supra* note 5, at 88,168. The potential for the future use of this financing source has influenced the behavior of potential target firms, who have begun to leverage up as an anticipatory defense. As Warren Buffet has remarked to an audience at Columbia University, the attempt to dismiss the junk bond based on the still-low volume associated with its current use is similar to dismissing the AIDS epidemic based on the number of deaths it caused in the 1960s. Remarks of Warren E. Buffet, CEO of Berkshire Hathaway Inc., at Columbia Law School Conference on Takeovers and Contests for Corporate Control (Nov. 13, 1985).

114. See Hertzberg, *Borrowing Time: Takeover Targets Find Loading Up on Debt Can Fend Off Raiders*, Wall St. J., Sept. 10, 1985, at 1, col. 6; Labich, *supra* note 109, at 83. According to a Salomon Brothers estimate, \$24.9 billion was spent on stock repurchases in 1984, up from \$7.6 billion in 1983. In 1985, stock repurchases climbed to \$37 billion. See Williams, *supra* note 12. This trend appears to have continued, but at a more modest rate of increase in 1986. See Jonas, Berger & Pennar, *supra* note 14, at 88. Their impact on specific transactions is also evident. For example, when Ted Turner made a hostile bid for CBS, his highly leveraged bid would have raised CBS' debt to 83% of its total capitalization. In response, CBS purchased 21% of its stock for \$955 million, thereby increasing its debt to 66% of capitalization. To finance this acquisition and also to signal that it could make still more repurchases, CBS increased its outstanding debt from \$508 million to \$1.35 billion. This left few unencumbered assets for Turner to leverage, and the loan agreement limited further borrowing by CBS to 75% of its capitalization. See *CBS's Debt Bomb*, FORTUNE, Aug. 5, 1985, at 8.

the combined assets of both companies. In effect, the target beats the bidder to the punch by borrowing up to its debt capacity and distributing the proceeds to its shareholders.

More generally, leveraging the firm is not simply a tactical defense that stalemates the modern junk bond financed, bust-up takeover; it is also the bidder's objective, which once achieved leaves it satisfied because it has profited by reducing the discount between stock and asset values. To the extent that "excess" resources are distributed to shareholders through pro rata repurchases, the disparity between the corporation's stock price and its asset liquidation value should narrow or disappear, and absent a highly visible discount the financial entrepreneur who is not interested in, or skilled at, operational management will take its profits and move on.

As noted earlier, the optimistic view of this sharp increase in corporate debt/equity ratios sees it as a correction to the suboptimal degree of leverage that was the product of management's risk aversion. Conversely, the pessimistic view is, of course, that many firms will be unable to sustain their debt service once the business cycle turns downward.¹¹⁵ Those who are sanguine about leverage point out that the stock market has responded favorably to financial restructurings that have increased debt levels¹¹⁶ and that net interest payments have not exceeded the growth in cash flow. Interest coverage ratios have, in fact, recently improved as a result of liberalized depreciation rules.¹¹⁷ Moreover, although corporate debt has increased as a percentage of book value, the optimists point out that book value provides a frequently misleading measure, because it is based on historical cost and we live in an inflationary world. As Exhibit A shows, if we look instead at the replacement cost of corporate assets (rather than their book value), the debt-to-equity ratio stood at 49.4%, rather than the

115. Probably the most careful and disturbing statement of this view is to be found in a recent speech by the president of the Federal Reserve Bank of New York on September 18, 1985. See Corrigan, *Public and Private Debt Accumulation: A Perspective*, FED. RES. BANK N.Y. Q. REV., Autumn 1985, at 1. Corrigan estimates that, after "abstracting from internally generated equity, the 1984-85 period will, if current trends continue, see the net retirement of \$150 billion of equity in the nonfinancial corporate sector — an amount which in nominal dollars exceeds the net issuance of equity by nonfinancial business over at least the entire post-Korean War period." *Id.* at 3. Moreover, this increase in private debt has largely "occurred on the upside of the business cycle and the downside of the nominal interest rate cycle." *Id.* Nor can it be explained as an attempt to beat inflation (by paying back debts with cheaper dollars on their maturity) because the rate of inflation is lessening. Corrigan attributes the growth in private debt in substantial part to "a very rapid retirement of equity which, in turn, is importantly — but not exclusively — related to leveraged buyouts and the threat of hostile takeovers." *Id.*

116. See Jensen, *supra* note 65, at 325 (summarizing stock price studies).

117. As of the end of the first quarter of 1985, net interest payments as a percentage of corporate cash flow stood at 23.7%, a level well below their 1982 peak of 33% and about equal to their 1970 level. See Straszheim, *supra* note 111, at 2.

81.4% level that results from use of a book value denominator. This level is slightly below the peak levels of 1970 to 1972, when debt exceeded 50% as measured on a current value basis. Alternatively, one can also measure the debt level against the market's valuation of the corporation's net worth. Exhibit A shows that this denominator produces a more volatile figure, which increased significantly in 1984, but leveled off in 1985 and is still well below previous peak periods.

Examining the debtor's financial condition also looks at only one side of the equation — and probably the least significant side. If there is a problem with leverage, why is it that creditors would not protect themselves adequately? Here, there are potentially disturbing answers. To the extent that the junk bond market is a new institution, it is possible that the necessary monitoring mechanisms have not yet developed adequately.¹¹⁸ One aspect of this problem involves the distinct possibility that the creditors purchasing these bonds have inadequate incentive to monitor their debtors. Many junk bond purchasers are either savings and loan associations or pension funds,¹¹⁹ and these classes of institutions receive their capital from individuals who are largely protected by government insurance (either the Federal Savings and Loan Insurance Corporation (FSLIC) or the Pension Benefit Guaranty Corporation (PBGC)). As a result, these investors have little reason to monitor the level of risk accepted by their financial institutions, and a classic moral hazard problem therefore arises, because the high returns paid on junk bonds are not counterbalanced by high risks to these depositors so long as they can look to government insurance.¹²⁰ This is a traditional problem in banking, and the

118. Some accounts suggest that junk bond purchasers are essentially relying on Drexel Burnham to make a secondary market into which they can quickly dump their securities if credit conditions worsen. Fears about Drexel Burnham's financial solvency in the wake of the Ivan Boesky scandal caused a major downturn in the junk bond market in late 1986. See Arenson, *supra* note 97, at F8, col. 5. The relevant point about Drexel Burnham's current dominance of this market is that it suggests that whatever credit monitoring is being done is largely conducted by one underwriter, which because of its near monopoly on this market is in a highly conflicted position. See Sloan & Rudnitsky, *supra* note 5. Given the existence of limited liability, Drexel Burnham may have inadequate incentive to monitor so long as the fees its partners receive from this business (up to \$15 million per annum in the case of the principal partner handling these transactions) exceed their equity that would be lost if the firm became insolvent.

119. As of late 1986, it is estimated that some \$120 to \$125 billion in principal amount of junk bonds were outstanding and were held by the following classes of investors in the following approximate amounts: insurance companies (\$40 billion), mutual funds (\$40 billion), pension funds (\$10 to \$15 billion), thrift institutions (\$10 billion), and individuals (\$15 billion). Rasky, *Tracking Junk Bond Owners*, N.Y. Times, Dec. 7, 1986, at F4, col. 3. Thus, the combined holdings of pension funds plus "thrifts" may amount to \$25 billion. Some experts believe thrift institutions hold even larger quantities of junk bonds and understate their holdings by improperly classifying these securities "as loans rather than investments and thus avoid reporting them." *Id.*

120. For such an analysis see Barth, Bisenius, Brumbaugh & Sauerhaft, *Regulation and the Thrift-Industry Crisis* (Oct. 2, 1985) (unpublished paper by economists at the Federal Home Loan Bank Board). Confirming their theory is the extraordinary position of at least one thrift —

traditional answer has been the use of regulatory monitoring by a variety of agencies. However, in the new era of deregulation, some of these constraints have been relaxed, and some financial institutions, such as Continental Illinois or Bank of America, may themselves be under shareholder pressure to accept greater risk.¹²¹ Whatever the reason, the apparent result has been a wave of bank failures unprecedented since the Great Depression.¹²²

Another, even more significant reason for skepticism about whether the credit risks associated with junk bonds have been properly evaluated by their purchasers has been suggested by Peter Drucker. As he points out,¹²³ pension funds, major purchasers of junk bonds, are typically "defined benefit" plans under which the corporate employer's contribution is reduced to the extent that the pension fund's assets earn above-market returns. Because the corporation's financial managers typically also supervise the pension fund, there is a built-in conflict of interest, with the corporation having an incentive to seek above-average returns for the fund (and accept above-average risks in so doing) in order to minimize its own required contribution.

Similar observations may be made about mutual funds, which engage in intense competition for investors' funds and which are subject to sharp fluctuations in the assets under their control as investors switch among funds based on their recent yields.¹²⁴ Yet, it is far from clear that the ordinary investor in a mutual fund is able to judge the

Columbia Savings & Loan Association — which at June 30, 1986, owned \$2.33 billion in junk bonds, or 28% of its total portfolio. See Hilder, *Heard on the Street: Thrifts With Junk Bond Holdings Recover Some Recent Losses, But Uncertainties Linger*, Wall St. J., Dec. 19, 1986, at 55, col. 3.

121. Two distinct reasons underlie this conclusion. First and most obviously, the managers of a financially troubled company may find it in their own rational self-interest to accept high-risk gambles to avoid ouster. Second and less obviously, as the equity component of the corporation's capitalization shrinks, it becomes increasingly in the interest of the equity holders to accept higher risk because more of the risk of loss will be borne by the creditors. See notes 180-83 *infra* and accompanying text. In this light, it is relevant that the Bank of America today has a capital structure in which "common shareholder's equity is only 2.8 percent of total assets." See *Bank of America Posts \$23 Million Loss*, N.Y. Times, Oct. 18, 1986, at 35, col. 2, 37, col. 3. These rationally risk-preferring equity holders will elect the board and ultimately control corporate policies.

122. Eighty percent of the 650 thrift institution failures since the establishment of the FSLIC in 1941 have occurred since 1979, and fifty percent of the 362 commercial bank failures since 1942 have occurred during this same period. See Barth, Bisenius, Brumbaugh & Sauerhaft, *supra* note 120, at 1.

123. Drucker, *supra* note 25, at 11-12.

124. See Lowenstein, *supra* note 26, at 297-304 (arguing that required quarterly disclosure by portfolio managers, which was adopted in 1978, has produced frenetic trading by funds and a higher willingness to accept risk). Mutual funds currently hold approximately \$40 billion in junk bonds. See note 119 *supra*. Another reason for the mutual fund industry's intense appetite for junk bonds may lie in the fact that the law restricts it from acquiring other risky investments. See note 142 *infra*.

level of risk that the fund has accepted. If there is little market penalty for accepting higher risk, funds will rationally do so. Other more general problems may also compromise the capacity of the debt market to appraise the risk on junk bonds, which will be reviewed later.¹²⁵

Still, the logical reform that these problems point to is not so much legal restrictions on the issuance of junk bonds as restrictions on their purchase. To date, it remains premature to conclude that junk bonds imperil the stability of any class of financial institutions, because they represent only a relatively small percentage of the total portfolio of any segment of the banking and investment industry.¹²⁶ Yet, past data may not predict the future in this rapidly changing, conflict-laden area. Although junk bonds financed no more than one percent of all tender offers between 1981 and 1984, an SEC study shows that this figure rose dramatically to 25% in 1985.¹²⁷ Moreover, at least in some regions, small government-insured financial institutions have invested very substantial percentages of their assets in this new class of debt security.¹²⁸

In overview, the impact of the junk bond revolution depends upon whether one's perspective is that of (1) a shareholder in the issuing corporation, (2) an employee or manager of such an issuer, (3) the bond's purchaser, or (4) the preexisting creditors of the corporation. From the shareholder's perspective, it seems illogical and socially counterproductive to restrict corporate access to a new and important source of capital simply because *some* purchasers may have proven imprudent and even reckless. Shareholders would argue that the more sensible reform would be to tighten and better enforce the regulations

125. For a more general discussion of imperfections in the debt markets, see notes 182-91 *infra* and accompanying text.

126. While analysts estimate the total junk bond holdings of mutual funds at between \$30 and \$45 billion as of December 1986, the Investment Company Institute places the total assets of the 1700 mutual funds it monitors at \$701.3 billion. Rasky, *supra* note 119. Similarly, pension funds, which hold between \$10 and \$15 billion in junk bonds, held total assets of nearly \$2 trillion in 1985. *Id.* Still, these holdings are not evenly distributed, and a relatively small number of mutual funds (some 53 according to Lipper Analytical Services) held just over \$23 billion in junk bonds at the end of 1986 (or more than half the total holdings of such bonds by all mutual funds). *Id.* A similar pattern is evident at savings and loan associations where the top ten holders of such bonds accounted for over 80% of the total holdings by thrift institutions, according to a Federal Home Loan Bank Board official. *Id.*

127. See SEC, *Noninvestment Grade Debt*, *supra* note 5, at 88,168.

128. Although junk bonds are a trivial percentage of the total industry's portfolio, they loom larger on a regional basis. Fifty-two percent of the junk bonds held by the 200 largest institutions were held by institutions in the San Francisco FHLB district, 24% by institutions in the Dallas district, and 18% by institutions in the Atlanta district. See CONGRESSIONAL RESEARCH SERVICE REPORT, *supra* note 5, at 38. This localized growth is consistent with their recent appearance and suggests high future growth, because financial institutions compete increasingly on a nationwide basis. See also note 120 *supra* (noting one savings and loan which, at June 30, 1986, owned \$2.33 billion of junk bonds).

governing the percentage of these purchasers' portfolios that could be invested in high-risk debt securities. Similarly, from the perspective of the junk bond purchasers, the fact that only a tiny percentage of all purchasers appear to have invested heavily in junk bonds suggests that sweeping new regulations are unwarranted.¹²⁹ Moreover, in the case of the largest group of purchasers — mutual funds — it is likely that the public invests only a small portion of its savings in the high-risk funds that so specialize. Thus, greater disclosure — possibly combined with a stricter registration requirement for the sale of junk bonds¹³⁰ — seems the most justifiable reform.

Only when we come to employees and existing creditors do we encounter interest groups whose oxen have truly been gored, but their entitlements are highly problematic. For employees and managers, higher corporate leverage, particularly achieved through the medium of junk bonds, has frequently been followed by significant layoffs.¹³¹

129. See notes 126 & 128 *supra*.

130. Junk bonds are today chiefly marketed on a "blind-pool," private-placement basis, because the purchasers are sophisticated institutions or individuals, and registration under the Securities Act of 1933 is not therefore required. Advance disclosure about the target is constrained by Rule 14e-3, 17 C.F.R. § 240.14e-3 (1986), which prohibits the bidder from communicating "material, nonpublic information relating to a tender offer" to other persons when "it is reasonably foreseeable that such communication is likely to result in" insider trading. An exception is carved out in Rule 14e-3(d) for communications to persons "involved in the planning, financing, preparation or execution of such tender offer." The ambiguity surrounding the scope of this exception and evidence of its abuse in the recent insider trading scandals suggests the desirability of an alternative procedure: post-announcement financing by those bidders eligible to use Form S-3. Currently, SEC Rule 415 permits shelf registration for issuances of debt securities only in the case of those issuers able to qualify for the use of Form S-3. See Rule 415(a)(1)(x), 17 C.F.R. § 230.415(a)(1)(x) (1986). Form S-3, in turn, provides that it may only be used for the registration of "investment grade securities," a term that clearly does not apply to junk bonds. See Form S-3, General Instructions, Instruction I(B)(2), 2 Fed. Sec. L. Rep. (CCH) ¶ 7152, at 6252 (May 4, 1983). Yet, the same disclosures given in connection with the tender offer will normally suffice to inform the purchasers of junk bonds and would be superior to the current blind-pool arrangement, which omits transaction-specific disclosure and also often leads to tipping of some prospective transactions. Ideally, a piggyback system of integrated disclosure using Form S-4, which is specially designed for merger and acquisition transactions, see Form S-4, General Instructions, 2 Fed. Sec. L. Rep. (CCH) ¶ 7162 (May 1, 1985), could be utilized to provide to the purchasers of the bidder's debt securities the basic information package that they need to evaluate the bidder's changed position in light of the acquisition transaction, and pursuant to shelf registration these disclosures could come after the announcement of a tender offer. The specifics of this proposal are beyond the scope of this article.

131. For recent descriptions of takeover-produced layoffs, see note 15 *supra*. See also Buzotta, *A Quiet Crisis in the Work Place*, N.Y. Times, Sept. 4, 1985, at A27, col. 2; *Middle Managers Are Still Sitting Ducks*, BUS. WK., Sept. 16, 1985, at 34 [hereinafter *Middle Managers*]; Prokesch, "People Trauma" in Mergers, N.Y. Times, Nov. 19, 1985, at D1, col. 3; Nielsen, *Management Layoffs Won't Quit*, FORTUNE, Oct. 28, 1985, at 46. Of course, any balanced account must acknowledge that product market competition is probably the principal reason for managerial layoffs, and in some cases (such as that of American Telephone and Telegraph which is currently laying off 24,000 workers) is the exclusive cause. But for other companies, such as CBS, which laid off 2000 workers one month after leveraging up its financial structure to defeat Ted Turner's hostile bid, or Phillips Petroleum, which fought off Boone Pickens, the takeover phenomenon appears to be the principal explanation. See Smith, *Sweeping Staff Cuts at CBS*

Here, however, a simple remedy is not apparent, because the firm's financing policy is quintessentially an internal corporate decision for the board. For existing creditors, the junk-bond revolution has come as a major surprise, and the issue is therefore best conceived of as one of transition policy.¹³² The available evidence strongly suggests that the holders of outstanding issues of debt securities have been adversely affected. In 1985, Standard & Poor's Corp. lowered a record 272 corporate debt ratings, half again as many as in 1984 and well above the previous peak of 246 set in recessionary 1982.¹³³ Yet, this record will clearly fall in 1986, as 264 ratings were lowered during the first nine months alone.¹³⁴ A survey by Moody's Investors Services found nearly one-third of the number of credit downgradings (and nearly half the total market value of the debt) resulted from "decapitalization" moves, such as stock repurchases, leveraged buyouts, and acquisitions, that appear to be takeover-related.¹³⁵ Still, the actual holders of junk bonds have experienced relatively low rates of default, for which risk they have also been well compensated by extremely high yields.¹³⁶ Uniquely, existing creditors are prejudiced by the junk bond

News, N.Y. Times, Sept. 20, 1985, at C30, col. 4; *The Shrinkage at Phillip Pete*, BUS. WK., May 27, 1985, at 46 (noting 10% work force cut).

132. See note 16 *supra* for a discussion of this perspective. Unless it can be shown that the debt market will not reequilibrate to some level at which risk and return are properly balanced, the transition issue becomes whether the holders of preexisting debt securities deserve greater regulatory protections against the issuance of new debt securities that will cause their securities to be downgraded by credit-rating agencies and therefore to decline in value. Such a claim is problematic because there is also the countervailing possibility that such persons may receive an unfair windfall from such regulation: that is, having been paid a high rate of interest based on the issuer's retaining the ability to issue more debt, such holders would now receive the benefit of a regulatory change that restricts or denies the issuer's ability to behave as it previously bargained to do.

133. See *Bondholders, Unite! Issuers Are Getting Away With Highway Robbery*, BARRON'S, Nov. 24, 1986, at 9 [hereinafter *Bondholders Unite!*]. For an earlier, similar study, see Labich, *supra* note 109, at 84 (discussing recent instances at Chesebrough-Ponds, Phillips Petroleum, Unocal, and Martin Marietta where takeover battles were the cause of the credit downgrading). Federal Reserve Board Chairman Paul Volcker has also connected the recent number of credit downgradings to the takeover-induced degree of leverage. See Statement by Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System, before the Subcommittee on Telecommunications, Consumer Protection and Finance of the Committee on Energy and Commerce, House of Representatives (Apr. 23, 1986) (on file at *Michigan Law Review*).

134. See *Bondholders Unite!*, *supra* note 133, at 9.

135. See *id.* For a similar finding, see *Takeovers and Buyouts Clobber Blue-Chip Bondholders*, BUS. WK., Nov. 11, 1985, at 113 [hereinafter *Takeovers and Buyouts*].

136. Various statistics exist on the default and loss rates on junk bonds (depending on definitions used and the time periods examined). A Drexel Burnham study computes a 0.47 percent loss rate, while an Altman study places the default rate at 1.60 percent and the loss rate at 1.02 percent. See CONGRESSIONAL RESEARCH SERVICE REPORT, *supra* note 5, at 13-14. These figures are, however, historically biased and do not show the impact of either (a) the recent major default by LTV Corp., or (b) the new phenomenon of "zero coupon" junk bonds, which defer interest until maturity and therefore by definition cannot default before maturity. See *LTV Bankruptcy Filing Underlines Risk in Junk Bonds, Standby Letters of Credit*, WALL ST. J., July 21, 1986, at 2, col. 2; Lowenstein, *Taking Issue With the SEC: Three New Reasons to Fear Junk*

revolution, but their entitlements are the most questionable. Over time, creditors, particularly those who purchase debt securities in the secondary market, may learn to pay greater attention to indenture covenants, to invest in shorter-term debt securities, to demand higher interest when managerial discretion to increase debt levels is retained, or to acquire voting rights on the theory that as a party unavoidably subject to residual risk they should also share in control decisions. Potentially, the line between debt and equity may begin to blur as long-term creditors find it simpler to structure "strip financings," under which they simultaneously acquire both voting equity securities and debt instruments, than to engage in costly contracting over negative covenants.¹³⁷

Arguably, the exposed positions of the existing debt securityholders can be analogized to those of the firm's incumbent managers, both of whom appear vulnerable to what can be termed shareholder opportunism. Just as the manager's expectation of deferred compensation and job security can be frustrated by a change in control, so is the preexisting debt securityholder injured by an unanticipated increase in corporate leverage. But why was this increase unanticipated? Today, negative covenants have become rare in the "investment grade" debt issued by large publicly held corporations.¹³⁸ Their relative absence seems best explained as a form of creditor "free riding" on the known risk aversion of managers. Perhaps creditors saw little need to engage in costly contracting to secure protections when they knew that managements themselves tended to resist higher leverage. As a result, creditors relied to their subsequent detriment on an implicit expectation that did not give them true contractual safeguards.

If so, do these creditors now deserve retroactive legal protection? Here, the analogy between preexisting creditors and managers breaks

Bonds, N.Y. Times, Aug. 24, 1986, at F3, col. 1 (discussing the declining quality of junk bonds, the impact of the new zero coupon format, and the fact that many purchasers were either uninformed or "willing to make a desperate, all or nothing bet").

137. Jensen and Meckling recognized that it was uniquely difficult for creditors to restrict risk-taking by the conglomerate firm, which could change its business strategy so as to accept more risk. Thus, they theorized that such firms would be more equity-financed than other corporations. See Jensen & Meckling, *supra* note 28, at 334-40. Recent developments appear to have proven them half right: creditors seem not to have restricted risk-taking, but equity levels are declining. See note 114 *supra*. "Strip financings" have become increasingly common in the leveraged buyout context. See notes 229-48 *infra* and accompanying text.

138. A recent empirical survey found that few large corporations include negative covenants in their debentures. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413, 425-26 (1986); see text at notes 190-91 *infra*. Other evidence also suggests that the purchasers of junk bonds are not aware of the terms in their provisions. See Nulty, *Irwin Jacobs Stirs a Junk Bond Brawl*, FORTUNE, June 9, 1986, at 104 (purchasers of junk bonds surprised to find that they could be redeemed by the issuer).

down. Creditors seldom have firm-specific capital at risk and typically hold diversified portfolios. Their injuries are therefore lesser. Moreover, from the shareholders' perspective, the recent trend toward higher corporate leverage has produced significant gains, possibly because shareholders are at last able to discipline excessive managerial risk aversion. Indeed, most market observers believe that the recent wave of leveraging through equity repurchases has boosted stock market values significantly.¹³⁹ Even if stockholders' gains may have come partially at the bondholders' expense, these gains appear to have vastly exceeded the bondholders' losses, and future creditors can adequately protect themselves, albeit at the cost of higher transaction and contracting expenses.

The immediate policy question is whether the Federal Reserve Board should subject junk bonds to greater regulation. Already, the Board has taken the first step in this direction when it subjected debt securities issued by "shell corporation" bidders to the margin rules. However, the consensus of informed opinion has been that the Federal Reserve Board's action has not significantly restricted the credit available to a bidder, and a host of obvious evasions appears possible.¹⁴⁰ The case against further restrictions is essentially that restricting junk bonds might significantly curtail the takeover's reach as an external check on the managements of the largest U.S. corporations.¹⁴¹ Curbing junk bonds means that greater size would imply relative immunity, thereby creating a strong incentive for inefficient empire-building by defensively oriented managements.

The evidence to date seems best read as justifying concern, but not strong action. The only clear abuse is that some institutions — especially pension funds and thrifts — have excessive incentives to accept

139. See *Changing the Rules: Attacking Junk Bonds, Fed Becomes a Player in the Takeover Game*, Wall St. J., Dec. 9, 1985, at 1, col. 6 (noting predictions by market traders and investment bankers that a substantial reduction in takeover credit would have a "profound impact on the stock market" because the supply of stock had recently declined in light of stock retirements and takeover activity).

140. *Id.* The Federal Reserve Board's action applied only to bidders that fell within the "shell corporation category." If, for example, Mesa Petroleum were to guarantee the debt of its shell subsidiary that bid for Unocal, or if it were to place substantial assets in the subsidiary, then the presumption that the loan was indirectly secured by the target's stock would probably be overcome. See 51 Fed. Reg. 1781 (1986) (to be codified at 12 C.F.R. § 207.112); see also Smith, *supra* note 9 (reporting use of several standard evasions to Federal Reserve rule).

141. The SEC's recent Junk Bond Study found that while new debt issuances played a trivial role in the financing of small to medium-size tender offers, they were central to the financing of tender offers for larger targets and accounted for 32.9% of the financing for the thirty largest tender offers between October 1984 and July 1985. Also, in 1985, while junk bonds accounted for only 5.7% of total financing in negotiated tender offers (*i.e.*, "friendly" ones), they accounted for 24.7% of hostile tender offer financing. See SEC, *Noninvestment Grade Debt*, *supra* note 5. Hence, the junk bond is uniquely important to the bidder and more so as the target's size grows.

risk because they still benefit from government insurance if they fail. Other institutions, particularly mutual funds, may also find that investments in junk bonds and corporate restructurings are the primary means by which they can achieve leverage, because they are otherwise subject to statutory limitations on borrowing.¹⁴² In this light, a case exists for modest changes in disclosure rules and regulatory policies toward selected classes of purchasers, but the case for tighter restrictions on takeover financing is far harder to make. While one cannot ignore the claim that higher corporate leverage threatens future insolvencies and broad social losses (with respect to which only shareholders tend to be fully diversified), it also must be understood that leveraging is at least as much a defensive strategy, which targets employ as willingly as do bidders. Yet, at present, the Federal Reserve Board's interpretation of the margin rules has as a practical matter chilled only hostile bids and not "friendly" mergers.¹⁴³ Given this imbalance and the ambiguous current state of the evidence on the risk of future insolvencies, the first regulatory step should not be to single out takeover financing, but rather to shift the regulatory focus to the purchasers of such securities. To be sure, any regulatory initiatives will have some chilling effect on the rate of takeovers, but a chill is preferable to a prohibition, and one that focused on the purchasers would also be evenhanded.

2. *The Rush to Restructure: Has the Twilight of the Conglomerate Arrived?*

Leverage is not the only technique by which the disparity between asset and stock values can be reduced. Undoubtedly, the hottest buzzwords in the executive suite over the last several years have been

142. The Investment Company Act of 1940 does not allow a mutual fund to issue "senior securities," and funds can only borrow from banks to the extent permitted by a 300% asset coverage ratio for any such loan. See Investment Company Act of 1940, § 18(f)(1), 15 U.S.C. § 80a-18(f)(1) (1982). The SEC views margin borrowing from a broker-dealer by a mutual fund as a forbidden issuance of a senior security. See Guidelines for Form N-1A, 5 Fed. Sec. L. Rep. (CCH) ¶ 51,208, at 39,173, 39,175 (Sept. 21, 1983) (Guides 7 & 10); see also 3 T. FRANKEL, THE REGULATION OF MONEY MANAGERS 289-91 (1980). Thus, mutual funds can only borrow from banks under the above-noted 300% asset coverage test.

The implications of this point are important. Normally, an investor who desires to hold a higher-risk portfolio may do so by simply assembling a market index portfolio and then leveraging it up by borrowing against it. However, because mutual funds are restricted from achieving such "homemade" leverage through direct borrowing, they must obtain higher leverage by an alternative route, such as buying securities that are themselves more leveraged, including junk bonds. This desire for higher-risk securities may create a demand both for junk bonds and also for financial restructurings by corporate issuers that produce higher leverage.

143. See note 140 *supra* and accompanying text. Because the Federal Reserve Board does not apply its "shell corporation" interpretation of the margin rules to mergers, financing which would be impermissible in the case of a hostile bid appears permissible in the case of a leveraged buyout by a merger. See *Interpretation of Margin Requirements*, 72 Fed. Res. Bull. 192 (1986).

“financial restructuring” and “deconglomeration.” The overall rate of restructuring since 1984 appears to have been unprecedented.¹⁴⁴ A better insight is gained when we examine specific examples during 1985 and 1986:

(1) In January 1985, ITT announced plans to sell off \$1.7 billion in assets by mid-1986.¹⁴⁵

(2) Shortly thereafter, Textron began to restructure itself by selling off units that represented one-third of its sales in the preceding year.¹⁴⁶

(3) In early summer, Gulf & Western sold its consumer and industrial products group to Wickes Cos. for approximately \$1 billion. This division had represented 40% of G & W's operating income in the prior fiscal year, and its sale was the culmination of a program under which G & W has shed divisions following the death of its founder, Charles Bluhdorn, in 1983, until it has today shrunk itself by half.¹⁴⁷

(4) In late summer, Mobil spun off Montgomery Ward, thus finally ending with a \$500 million write-off an experience that ranks as one of the most disastrous acquisitions in financial history.¹⁴⁸

(5) Also over the summer, Crown Zellerbach announced plans to split itself into three separate operating groups that would be separately held by shareholders.¹⁴⁹ Although ultimately withdrawn when the hostile bidder (Sir James Goldsmith) succeeded in gaining control, this example shows that deconglomeration can even be a postbid defense.

(6) In late August, Westinghouse indicated that it would sell its successful and much-coveted cable television business as part of a financial restructuring, because, it acknowledged, the stock market simply would not reflect the value inherent in the cable business so long as it remained buried within Westinghouse's broader portfolio of companies.¹⁵⁰

(7) In October, The Beatrice Companies announced plans to sell

144. See note 10 *supra*.

145. See *G & W's Crash Diet*, FORTUNE, July 8, 1985, at 8, 9 [hereinafter *G & W's Crash Diet*]; see also Magnet, *Is ITT Fighting Shadows — Or Raiders?*, FORTUNE, Nov. 11, 1985, at 25 (in which one former ITT executive describes the decisionmaking of his colleagues as “panic-stricken”).

146. *G & W's Crash Diet*, *supra* note 145, at 9.

147. *Id.* at 8; see also Landro, *Reversing Course: Davis Reshapes G & W Into an Entertainment and Financial Concern*, Wall St. J., June 10, 1985, at 1, col. 6.

148. See Leib, *Mobil Plans to Divest Ward Unit*, N.Y. Times, May 7, 1985, at D1, col. 6.

149. Stevenson, *Settlement for Crown, Goldsmith*, N.Y. Times, May 27, 1985, at 33, col. 6.

150. Cole, *Electrical Maker Sets Buyback*, N.Y. Times, Aug. 29, 1985, at D1, col. 6.

off four divisions, including Avis, Inc., whose total sales were over \$1 billion; by year's end, Beatrice would nonetheless go private in the largest buyout on record.¹⁵¹

(8) Within the oil industry, restructuring has reached epidemic proportions. ARCO announced in May that it would sell or close two thousand gas stations and close its major East Coast refinery.¹⁵² Freeport-McMoran has spun off its oil and gas operations by creating trust units that trade separately on the New York Stock Exchange.¹⁵³ Amoco has spun off its mineral divisions, the Cypress Minerals Co., and Unocal is spinning off its reserves in the Gulf of Mexico into a limited partnership;¹⁵⁴ Chevron is disposing of its East Coast retailing and refining operations;¹⁵⁵ and Mesa Petroleum, as usual leading the way, announced that it would in effect begin to liquidate itself by converting itself into a master limited partnership.¹⁵⁶

(9) Finally, the ink was not dry on the Allied-Signal merger agreement before that company spun off thirty subsidiary operations into an independent concern having \$3 billion in annual revenues.¹⁵⁷

These developments are pieces of a larger pattern. One recent study reports that 23% of the nation's leading 850 corporations have undergone an "operational restructuring" since the beginning of last year, usually selling or spinning off divisions.¹⁵⁸ Closely associated with this trend is the number of divestitures (900) that occurred in 1984. Although there have been prior sell-off waves in U.S. business history, the dollar volume of these transactions was a record.¹⁵⁹ Unlike the earlier sell-off wave that followed the conglomerate merger

151. *Beatrice Will Sell Avis and Three Other Units*, N.Y. Times, Oct. 2, 1985, at D5, col. 1.

152. Hayes, *Atlantic Richfield to Dispose of 2,000 Gas Stations in East*, N.Y. Times, Apr. 30, 1985, at 1, col. 2.

153. Curran, *Corporate Moves to Lift Stocks*, FORTUNE, July 22, 1985, at 121, 124.

154. Hayes, *The Oil Industry Shake-Up*, N.Y. Times, May 7, 1985, at D1, col. 3.

155. *Chevron Properties on Block*, N.Y. Times, Sept. 4, 1985, at D1, col. 3.

156. Cohen, *Mesa Holders Could Get Annual Return Up to 13.4% Under Partnership Plan*, Wall St. J., Sept. 4, 1985, at 6, col. 4.

157. Crudele, *30 Allied-Signal Units to Form New Company*, N.Y. Times, Nov. 21, 1985, at D1, col. 4. Those companies spun off were those not "highly regarded in the financial community," according to the *New York Times*, which again suggests that the focus was on the disparity between asset and stock values.

158. Buzzotta, *supra* note 131. Another study by Eugene Jennings of Michigan State University found that since 1980, 89 of the 100 largest U.S. companies have reorganized to reduce management levels. See *Middle Managers*, *supra* note 131.

159. Prokesch, *U.S. Companies Weed Out Many Operations*, N.Y. Times, Sept. 30, 1985, at A1, col. 3, D5, col. 3 (quoting data from W.T. Grimm & Company, which also placed a record market value of \$29.4 billion on the assets divested in 1984). The figure of 900 divestiture transactions in 1984 is not a record, although it is above the average level of 767 that prevailed between 1978 and 1981. See D. Ravenscraft & F.M. Scherer, *Mergers and Managerial Performance* (paper prepared for Columbia Law School Conference on Takeovers and Contests for Corporate Control, Nov. 15, 1985). Unlike the earlier sell-off waves described by Ravenscraft

boom of the 1960s, the selling firms in this wave were not generally seeking to reinvest the proceeds in other acquisitions (much as in a gin rummy game), but were instead paying out these proceeds to shareholders in an effort to downsize the firm.

By all accounts, restructurings have been very profitable for shareholders, have elicited a positive stock market reaction on their announcement, and have helped fuel the market's recent advances.¹⁶⁰ But what else does this pattern imply? As always, different factors are at work. Within the oil industry, the basic movement was clearly to drop marginal retail and refining operations. Today, even those firms that fought Boone Pickens bitterly have conceded his point that corporate expansion should not be pursued in that industry in the face of declining profitability.¹⁶¹ Thus, whether oil industry firms have spun off assets and ceased to be vertically integrated or whether they have repurchased their own shares (as Exxon has done),¹⁶² they are essentially heeding the capital market's preference for the return of capital that would yield poor returns if it were retained in the firm.¹⁶³ In this light, the oil industry experience is the best case study of the efficiency-enhancing attributes of the hostile takeover. Within this industry, the takeover threat appears to have curbed the tendency toward empire-building that the managerialist theorists correctly identified as a central drive of management. The irony here is that while the managerialists have tended to view acquisitions skeptically (particularly conglomerate acquisitions) as simply another route to inefficient em-

and Scherer, the divesting firms today are reducing their total asset size by as much as 30 to 50%. See notes 145-48 *supra*.

160. Stock price studies have shown that leverage-increasing transactions produce statistically significant positive increases in the corporation's common stock. See Jensen, *supra* note 65, at 325. In addition, a study in late 1985 by Goldman Sachs & Co., the investment banking firm, estimated that "70% of the Standard and Poor's 500 stock index's 13% price appreciation since the start of 1984 came from actual and anticipated restructurings." See *Takeovers and Buyouts*, *supra* note 135.

161. For recent statements by industry leaders that the oil industry has largely accepted the need for restructuring along the lines originally advocated by Boone Pickens, which strategy emphasized reduced exploration expenditures, buying reserves rather than searching for them, and a self-liquidating approach that views an oil corporation as a "wasting asset," see Daniels, *Restructuring the Oil Industry*, N.Y. Times, Sept. 2, 1985, at 27, col. 3; Schmitt, *supra* note 15; Hayes, *supra* note 154; Williams, *Big Oil Starts Thinking Smaller*, N.Y. Times, Mar. 17, 1985, at F1, col. 2.

162. Although probably the least threatened of all oil companies, given both its size and its ability to find cheap reserves, Exxon repurchased its shares at the rate of one million per week between the last half of 1983 and late 1985. See Vartan, *Market Place: Some Caution on Oil Stocks*, N.Y. Times, Nov. 1, 1985, at D8, col. 2.

163. Professor Jensen has collected evidence that during the late 1970s the oil industry was earning low to negative returns on exploration and development expenditures and that the announcement of increased such expenditures elicited a negative stock market reaction. See Jensen, *supra* note 65, at 326-27. Yet, such expenditures advanced managerial interests and so were continued in the face of shareholder opposition, until the intervention of hostile bidders.

pire-building, the net effect of takeovers may be to downsize the American corporation. Those who focus only on the bidder's motives and its tendency to overpay have missed the key fact that the general deterrent effect of the takeover on target managements has probably done more to prune corporate empires than to build them.¹⁶⁴

Outside of the oil industry, where most of the targets could not be described as conglomerates, the transition seems harder to assess. ITT, Gulf and Western, and Textron represent the very prototypes of the modern conglomerate organization. Their collective decisions to spin off a material portion of their assets represent a collective rethinking of the optimal size of the modern multi-divisional firm. Tactically, these decisions were understood by all observers as a form of *ex ante* takeover defense: assets were spun off or sold by these firms because the asset value of the firm on a break-up clearly exceeded the firm's value in the stock market by a margin sufficient to attract the bust-up takeover bidder. That these firms undertook this step represents a significant concession on their managements' part. That is, having finally recognized that the standard operational moves available to senior management (*i.e.*, cost-cutting, increased dividends, stock repurchases) would not affect the disparity between stock and asset value sufficiently to forestall a bust-up takeover, these managements have in effect accepted the capital market's judgment and downsized the firm themselves in order to escape the threat of ouster. In sum, this new sell-off wave followed, and is a product of, the financial developments that have enabled the takeover to threaten the very largest U.S. corporations. What is most distinctive about this new sell-off wave is the identity of the sellers — companies within the Fortune top twenty industrial corporations who, as late as 1980, were not seriously threatened by takeovers.

Viewed strictly in terms of financial theory, this trend can thus be seen as another instance of the market forcing managers to maximize value for their shareholders. Examined more closely, however, there are some anomalies that require at least a qualification of this conclusion. Curiously, it is often the highest-growth division — the "crown jewel" — that is spun off. Westinghouse's decision to divest its cable

164. Those who have been most critical of the efficiency claims made for conglomerate acquisitions — such as Dennis Mueller, Robert Reich, and F.M. Scherer — have tended also to doubt the disciplinary thesis that the hostile takeover replaces less efficient managers with more efficient ones. See sources cited at notes 89 & 108 *supra*. Although this author has also examined and expressed reservations about the disciplinary thesis, see Coffee, *supra* note 2, the efficiency claims that can be made for the recent operation of the hostile takeover are much broader than this narrow disciplinary thesis. The more sustainable claim is that the takeover is squeezing the organizational slack out of corporate America. The problem with this claim is that this purging may produce serious diseconomies.

television assets is a good illustration.¹⁶⁵ How does one explain this? Perhaps we should start by returning to the managerialist's premise that managers have a desire to maximize corporate size and growth. If valid, this premise logically applies to negative growth decisions (*i.e.*, divestitures), as well as to acquisition decisions, and it suggests that managers would attempt to minimize the total diminution in corporate size. Thus, they might prefer, albeit reluctantly, to spin off a small "crown jewel" division that could attract a bust-up bidder, rather than retain the crown jewel and dispose of all other assets (which strategy would equally end the disparity between asset and stock value). As a result, although the market may be forcing a diminution in size, it is not clear that the specific portfolio that shareholders are left holding in the remaining firm was chosen on the basis of efficiency-related criteria. To be sure, the macroeconomic distortions that such a bias would cause may be minimal, because the high-growth winner can be sold for cash, which could be reinvested. Yet, it remains curious that managers have frequently chosen to spin off assets to shareholders rather than sell them at the frequently higher market price that these assets could command in the asset market. Again, the determinative consideration may be that of managerial self-preservation: a cash sale would raise the corporation's liquidity level and thus might make the corporation a likely takeover target. Alternatively, the cash could be reinvested in a new acquisition, but management may fear that this would restore the disparity between stock and asset values. In contrast, a spin-off (or a leveraged buy-out in which the division's management purchases the division for substantially noncash consideration) neither increases the corporation's liquidity nor maintains its prior scale.

To the theorist, the major issue posed by the "deconglomeration" movement is how to reconcile it with the Williamsonian Model that sees the M-Form Firm as able to outperform the capital market. Why should such a broad trend toward a smaller portfolio size have arisen and involved such prototypical M-Form Firms as ITT, Gulf and Western, and Textron? In this author's judgment, a modification of the Williamsonian model is necessary, but not its abandonment. The deficiency in the current statement of this model is threefold: first, it fails to recognize the significance of the emergence of the institutional investor who holds a diversified portfolio of securities; second, it gives too little attention to the disciplinary impact of the takeover on the

165. See Cole, *supra* note 150. A corporate spokesman for Westinghouse said that the cable properties were being sold "because our stock price doesn't reflect the value of the cable." *Id.*

older U-Form Firm; third, it ignores the tendency for the M-Form Firm to make an excessive investment in monitoring staff.

To understand these contentions, let us begin with the principal advantages of the M-Form Firm. The major claim is that the M-Form Firm has superior monitoring ability because its senior management is essentially able to make capital budgeting decisions that allocate the firm's resources among competing semi-autonomous divisions more swiftly than can the market. In effect, the M-Form Firm is itself a miniature capital market. This claim is highly credible, although other theorists have offered somewhat different models of how a firm strategically handles its portfolio of products and divisions.¹⁶⁶

Now, let us place this thesis in an updated perspective as it has been affected by the appearance of the hostile takeover. Although hostile tender offers appeared in the 1960s, they were not able to threaten seriously the upper tiers of the Fortune 500 until the late 1970s. Only with the appearance of the two-tier takeover could firms as large as Conoco or Marathon Oil be attacked in the early 1980s and forced to enter shotgun marriages with "white knights" (DuPont and U.S. Steel, respectively). Next, increasingly in the 1980s, the development of new financing techniques, and ultimately the appearance of the "junk bond," made it possible for relatively small bidders, including collections of individuals, to tender for very large concerns (*e.g.*, Gulf, Phillips Petroleum, Unocal, CBS, Revlon, USX, etc.).¹⁶⁷ With this development in the 1980s, classic financial entrepreneurs, such as Carl Icahn and Boone Pickens, could essentially seek to arbitrage any significant disparity between stock market value and liquidation value.

The impact of these developments was arguably twofold: First, the threat of the takeover may have initially threatened U-Form Firms more severely than M-Form Firms because, being less well monitored, the potential disparity between stock and asset values was greater in these firms, thus making them more inviting targets. This hypothesis partially explains why the initial targets of the new takeover wave over the last five to eight years were largely U-Form Firms. Essentially, oil giants such as Gulf, Cities Service, Getty Oil, and Phillips Petroleum were U-Form Firms. However, as a result of these takeovers and the general deterrent threat they generated, it is reasonable to expect that "agency costs" in the U-Form Firm were reduced. By the same token,

166. See, *e.g.*, G. DONALDSON, *supra* note 53, at 144-51 (offering an alternative model of how a corporation strategically handles its portfolio of companies over their life cycle). Donaldson compares his approach to that of the Boston Consulting Group's matrix. *Id.* at 151 n.4. Both Donaldson and the Boston Consulting Group see a life cycle to the typical division or product group, whereas Williamson makes no such assumption.

167. See notes 3 & 4 *supra*.

the existence of this external monitoring force reduced the differential in agency costs between the M-Form Firm and the U-Form Firm. Hence, even though the M-Form Firm could engage in much-superior internal monitoring, the existence of an external monitoring system that was less costly to target shareholders reduced the comparative advantage of the M-Form Firm. The predictable next step would then be that less successful M-Form Firms would become takeover targets to the extent that their break-up value significantly exceeded their stock value. This, of course, is what has concerned ITT, Gulf and Western, Textron, and CBS.

Now, add to this history the impact of the institutional investor's rise. This development also occurred largely in the 1960s, but the percentage of market trading attributable to these investors has continued to rise, particularly as their performance has been more closely monitored by their clientele because of public reporting requirements imposed in the 1970s.¹⁶⁸ Because the institutional investor already holds a diversified portfolio, it has less interest in investing in diversified conglomerates and certainly should not pay a premium for such stocks. The institutional investor is also engaged in a continual process of portfolio revision. Whenever an exogenous event (such as a merger or liquidation) causes a given firm in its portfolio to disappear or fundamentally change its character, the institutional investor must search for a replacement stock to fill this niche. Given this continuing search for stocks to fill specific niches in a portfolio, institutional investors would rationally tend to disinvest in broadly diversified conglomerates.¹⁶⁹

In addition, institutional investors are not all alike. Not only do they naturally differ in their taste for risk, but in an intensely competitive market for funds, many institutional investors find it useful to distinguish themselves as occupying a special niche. Thus, a given mutual fund may specialize in searching out high-growth, high-risk stocks (*i.e.*, stocks with a high beta value). Here again, the diversified conglomerate will not satisfy this taste because the more it approaches full diversification, the more it resembles a market index fund. Prior to the recently acquired capacity of bidders to tender for very large firms, the large M-Form Firm had less reason to be greatly concerned

168. See Lowenstein, *supra* note 26, at 297-304 (noting possible impact of Schedule 13-F, which was adopted in 1978 and requires quarterly reports from portfolio managers holding more than \$160 million in funds). Professor Lowenstein's provocative thesis is that quarterly disclosure has compelled more active and even frenetic trading among fund managers.

169. Another possible reason is that institutional fund managers justify their high fees by searching for "undervalued" stocks, even if this search is futile, and not by investing in index funds or diversified conglomerates. See notes 94-95 *supra* and accompanying text.

about the tastes and needs of institutional investors.¹⁷⁰ Yet, with the appearance of the bust-up takeover, this indifference to the market's taste is no longer prudent.

Viewed more broadly from an industrial organization standpoint, it is a curious industrial structure that superimposes a diversified portfolio managed by institutional investors on top of a firm structure that also manages a somewhat less diversified portfolio of operating divisions. To say that there is a redundancy here is not to say which level is superfluous, but it is to suggest that such an industrial structure is unstable. The level of optimal firm investment in monitoring cannot be determined by reference to the firm level of organization alone. As the amount of such investment increases at the investor level, pressures should grow to reduce parallel investment at the firm level.

So what should happen? The massive restructuring among conglomerate firms appears to be producing not a return to the traditional U-Form Firm, but rather firms whose operations span a narrower range of goods and services. In the future, the M-Form Firm will still likely manage a portfolio of divisions, but these divisions may become more concentrated in a narrower sector or sectors of the economy. In the vocabulary of Wall Street, these firms will seek a sharper image; or, in our vocabulary, they will remain multidivisional firms because of the M-Form Firm's superior monitoring capacity, but they will operate over a narrower range to please investors who resist fully diversified conglomerates. This appears to be exactly what has happened at Gulf and Western, which has repositioned itself as an entertainment and financial concern, having sold its industrial and consumer divisions in 1986.¹⁷¹ In short, the sheer size of the M-Form Firm may not shrink (other than temporarily), but its span of operations should. This will occur not because the M-Form was necessarily a less efficient monitor than was theorized (although this hypothesis is also possible), but because the M-Form Firm's ability to reallocate capital across divisions is not prized by institutional investors who can do this themselves. Over the long run, the one certainty is that firm structure cannot remain unaffected by capital market structure and the tastes of the institutional investor.

II. THE PROBLEM OF RISK

In overview, the social implications of the foregoing trends for per-

170. Gordon Donaldson views management's attention as having essentially focused on the product market and the goal of self-sustaining growth, not return on capital. However, he notes a shift over the period of his study. See G. DONALDSON, *supra* note 53, at 5-6, 84-86.

171. See Landro, *supra* note 147.

sons other than shareholders may seem to be partially offsetting. On the one hand, increased corporate leverage has alarmed those whose primary concern is with the possibility of a wave of corporate bankruptcies. On the other hand, the takeover's recent tendency to trim large conglomerates by forcing them to sell or spin off assets may reassure those who have been concerned about either the large conglomerate's asserted ability to engage in low-visibility anti-competitive practices or its political power.

For those who are participants in the corporation, however, there are more specific and less obvious implications in these trends, implications that ultimately lead up to the normative issue of the non-shareholder constituencies' entitlements in the public corporation. Part II will first consider the takeover's impact on corporate managements' incentive to accept high-risk gambles, then turn to the interrelation of risk and leverage, and finally attempt a preliminary social accounting of who wins and who loses under the new takeover regime.

A. *The Moral Hazard Problem*

Let us begin with a simple example of the moral hazard problem as applied to corporate decisionmaking. Consider the position of a CEO whose corporation is rapidly approaching insolvency and who has a choice between two investment decisions: Investment *A* will yield an attractive return well in excess of his company's historic cost of capital and carry relatively little risk. Investment *B* is much riskier but alone offers the possibility, albeit remote, of a bonanza payoff that will prevent insolvency. Ordinarily, the CEO (and his shareholders) would prefer the higher net present value associated with Investment *A*, but when bankruptcy looms (with the result that management will be replaced in control by the firm's creditors) it is entirely rational for them to prefer Investment *B*. This incentive to accept risky investments arises ultimately because the manager and the shareholders enjoy limited liability. Put simply, they have nothing to lose from Investment *B* and nothing to gain from Investment *A* (because the returns it generates will only go to the firm's creditors).

The standard literature on corporate finance recognizes that limited liability can give rise to moral hazard problems, such as that just described, and that this danger grows in direct proportion to the degree of leverage in the corporation's financial structure.¹⁷² What has

172. See Jensen & Meckling, *supra* note 28, at 334. Jensen and Meckling describe the incentive effects on the owner-manager of the highly leveraged firm as follows:

Potential creditors will not loan \$100,000,000 to a firm in which the entrepreneur has an investment of \$10,000. With that financial structure, the owner-manager will have a strong

not received adequate attention, however, is that the threat of a hostile takeover can place the manager in an equivalent position.

To see this, consider now the CEO of a firm that is reputed to be a takeover target. His investment bankers tell him that unless the firm's stock rises sharply, the firm will be "in play." In that event, he can anticipate that he will be ousted in the wake of an eventual takeover by someone. Once again, an incentive arises to accept risky investments (or make risky strategic decisions) that otherwise would be disdained, because the manager knows that *he* will not be worse off if the investment or project fails. The only difference here is that in this variation his preference for the high-risk/high-payoff strategy conflicts with that of the shareholders, who have no desire to avoid a takeover bid or to accept high-risk gambles (whereas in the first hypothetical the shareholders as well as the CEO would wish to accept the one alternative (Alternative *B*) that could possibly avert bankruptcy). The conclusion that managements may sometimes behave in a risk-preferring fashion may seem to contradict this article's basic premise that managers tend to be more risk averse than shareholders with regard to their corporation. Yet, there is no contradiction. The manager's utility function remains constant, but whether he will disdain a desirable risk or accept an excessive one depends in each case on what will preserve his status of control.

Although much commentary has recently asserted that managers are forced to take a "short-term" perspective because of the threat of a hostile takeover that will displace them,¹⁷³ the underlying phenomenon, to the extent it exists, might be better described in the foregoing terms as a moral hazard problem. That is, rather than viewing managers as pressured into focusing on the short run to the exclusion of long-run considerations, it may be more accurate to say that they have an incentive to accept high-risk gambles that are not in their shareholders' interests. This hypothesis has greater explanatory power than the "short-run" hypothesis, in part because it does not require discussion of (1) why the target firm's shareholders should not have the right to force its management to focus on the short run if they so desire, or (2) why the firm's stock value would not fall further if shareholders had a

incentive to engage in activities (investments) which promise very high payoffs if successful even if they have a very low probability of success. If they turn out well he captures most of the gains; if they turn out badly, the creditors bear most of the costs.

In effect, this is a "moral hazard" problem, and an unlimited supply of junk bonds would raise both this problem and its corollary, the "adverse selection" problem, which suggests that those wanting to take such extreme risks would be the first to leverage up.

173. For a representative statement of this view, see Drucker, *supra* note 25. But see Pound, Lehn & Jarrell, *Are Takeovers Hostile to Economic Performance?*, REGULATION, Sept./Oct. 1986, at 25, 28-31 (finding empirical data to refute this thesis).

longer-term time preference. Information about the level of the risk accepted is inherently soft and may be withheld from the market by managers who wish to understate these risks.

The problem with this moral hazard explanation is that it is endemic to any system of accountability, corporate or political. A president whose popularity plummets in public opinion polls may have an incentive to manufacture a crisis or take dramatic action, when a more prudent course of action would be in the best interest of the citizenry.¹⁷⁴ But, even if this is true, one would hardly suggest the abolition of elections as a remedy. Similarly, if one views the takeover as a mechanism of accountability, it — or a proxy contest or, for that matter, any other conceivable system for disciplining managers — will produce an incentive for managers to accept higher risk when they are in a position where they face the potential of being disciplined.

What then is distinctive about the takeover as a form of accountability? One answer is that its threat of discipline is constant and unrelenting, whereas other mechanisms of accountability tend to focus their threat on specific, periodic moments (e.g., a quadrennial presidential election, an annual meeting of shareholders, etc.). As a result, the moral hazard problem is generalized under the discipline of the takeover, while it would tend to exist only during periodic moments under other systems of accountability. Put differently, the regime of the takeover is analogous to a political system in which the President could be forced to stand for election repeatedly and at any time at the decision of any opposition party.

If one accepts this analogy, the frequently heard argument that takeovers excessively divert managerial time and attention gains at least some plausibility. In turn, this suggests that more accountability is not always better. Rather, once a tradeoff between diversion of managerial time and shareholder accountability is posed, it follows that there may be an optimal middle ground — a level of accountability that if surpassed produces greater loss in terms of forgone managerial efficiency than it yields in terms of shareholder gain through reduced agency costs.¹⁷⁵

174. Professor Susan Rose-Ackerman has developed a formal theory that captures this intuitive point. See Rose-Ackerman, *Risk-Taking and Reelection: Does Federalism Promote Innovation?*, 9 J. LEGAL STUD. 593 (1980).

175. This analysis suggests that shareholders might be better served by a charter provision that restricted takeovers so that they could only occur at specified periodic intervals (for example, once every four years), thereby reducing the diversion of managerial time in the interim and giving management a breathing space within which to demonstrate the wisdom of its plans. If so, why have firms not adopted such a charter provision? Several answers are possible: First, there is considerable legal uncertainty about the validity of any such provision which may be in conflict with, and preempted by, the Williams Act. See notes 287-90 *infra* and accompanying text. Sec-

B. *Risk and Aspiration Levels: The Social Psychologist's Viewpoint*

While the economist's concept of moral hazard simply assumes that individuals will gamble when they have little or nothing to lose, social psychologists have developed a subtler theory that seeks to explain in a different manner how individuals will behave with respect to risky decisions. Based on observations and experimental studies, Professors Kahneman and Tversky have concluded that individuals do not simply compare the expected values of different alternatives, as standard economic theory assumes.¹⁷⁶ Rather, they find that individuals begin with a reference point (or aspiration level) that they seek to achieve. This premise seems reasonably close to that of organization theorists, such as Herbert Simon, who long ago postulated that organizational decisionmaking occurs against a backdrop of specific target levels of profit or growth.¹⁷⁷ The specific contribution of "prospect theory," as expounded by Kahneman and Tversky, is its claim that individuals will prefer lower-risk (lower-variance) options so long as they are performing above their aspiration level, but will opt for higher risk (higher-variance) options when they are below their aspiration. In effect, there is a "preference reversal" as individuals move from being risk preferrers to risk averters, or vice versa, depending on whether they are performing above or below their aspiration level.¹⁷⁸

Translated into the corporate context, this theory has useful appli-

ond, managements may prefer to restrict takeovers altogether, through tactics such as "poison pills" and "lockups," rather than to concede the legitimacy of capital-market discipline at regular intervals. Finally, shareholders may fear that management could "stack the deck" through any of a number of tactics if takeovers were limited to specified periodic windows. Still, the idea that there may be an optimal level of accountability that does not require the corporation to be at all times subject to a takeover merits further attention. See note 279 *infra*.

176. Kahneman & Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 *ECONOMETRICA* 263 (1979); see also Fishburn, *Mean Risk Analysis with Risk Associated with Below-Target Returns*, 67 *AM. ECON. REV.* 116 (1977); Payne, Laughhunn & Crum, *Translation of Gambles and Aspirational Level Effects in Risky Choice Behavior*, 26 *MGMT. SCI.* 1039 (1980).

177. H. SIMON, *supra* note 79.

178. Some research shows that decisions are reached by first classifying the outcomes of each choice as gains or losses in terms of whether the outcome is above or below the aspiration level. When expected values are above the target point, decisionmakers are risk averse — that is, they will tend to prefer the choice with least downside risk (or variance extending below the aspiration level). Conversely, managers become risk preferrers when each choice has an expected value below the aspiration level. See Payne, Laughhunn & Crum, *Further Tests of Aspiration Level Effect in Risky Choice Behavior*, 27 *MGMT. SCI.* 953 (1981); Laughhunn, Payne & Crum, *Managerial Risk Preferences for Below-Target Returns*, 26 *MGMT. SCI.* 1238 (1980).

In this article's terminology, management might — as writers such as Baumol, Marris, and Donaldson have argued — logically prefer a risk-averse, profit-satisficing policy that maximized growth, not profit, so long as they were operating above their aspiration level, which I would loosely define as that level of profits that avoids their ouster. But, once legal and institutional changes have increased the threat of a takeover, the aspiration level shifts upward to that profit level necessary to maintain them in office, and they may as a result tend toward a more risk-preferring style at the same level of profitability.

cations because it helps reconcile the perspective of the “profit-satisficing” theorists with contemporary realities. Essentially, the well-known view of such writers as Galbraith, Marris, and Baumol that corporate managers tend to behave in a highly bureaucratic manner and do not vigorously pursue profit-maximizing policies¹⁷⁹ can be translated into a statement that these managers, having met their aspiration level, thereafter act in a risk-averse manner and pursue growth over higher profitability.

The key implication to be derived from Kahneman and Tversky’s framework involves a factor that has changed since Herbert Simon and his colleagues first put forward their theory of profit-satisficing. Basically, the relevant reference point — the manager’s aspiration level — has moved upward, chiefly because of the appearance of the hostile takeover. At the time Galbraith, Marris, or Baumol wrote their principal pieces, the hostile takeover was not a visible threat and did not significantly constrain the behavior of the manager in the large public corporation; nor would a bust-up takeover have made sense in this era, because stock values generally exceeded asset values by a substantial margin through the “go-go” market of the 1960s. Whatever the reason, the hostile takeover was then an infrequent phenomenon (at least for large firms), and prospect theory holds that individuals tend to ignore (or discount heavily) dangers that have low base expectancy rates. As a result, the typical manager’s aspiration level then could be said to have been only to achieve that “satisfactory” level of profit that protected him from shareholder revolt or creditor dissatisfaction. Of course, the manager would still pursue greater profits, but in doing so he would tend to opt for the safer, lower-risk alternative.

Once hostile bidders proved able to capture large public corporations, however, the aspiration level of corporate managers shifted upward in response to the increased threat of ouster. Definitionally, their aspiration level can be said at all times to have been the achievement of that level of profits that protected them from ouster. This level has increased substantially, however, now that financially stable, highly solvent firms have become targets when their stock prices lag behind those of other firms in the same industry or when they have an asset value in excess of their stock market capitalization. The upshot then is that many, and perhaps most, senior corporate managers may today subjectively feel that they are performing below the necessary level of profitability that will protect them from ouster. In consequence, a massive “preference reversal” — a shift in attitude from risk

179. See notes 49-58 & 72-79 *supra* and accompanying text.

aversion to risk preference — may have occurred within senior corporate echelons. In summary, this perspective does not claim that human nature has changed or that the manager's utility function has been modified. Rather, it simply relies on empirical research gathered by social psychologists to reach the intuitively credible conclusion that managers, like the rest of us, are capable of behaving very differently with respect to risky decisions when their most important goals are at stake.

C. *Risk and Leverage*

Standard finance theory recognizes that the shareholder in a highly leveraged firm will prefer a higher-risk (higher-variance) course of action than would the same shareholder in a less leveraged firm.¹⁸⁰ This is because the greater the degree of leverage, the more the downside risk falls not on shareholders, but on the firm's creditors. As the residual claimant, the shareholders receive all the upside return, but, because they have limited liability, they can avoid downside loss, except to the extent their capital is invested in the firm. Thus, the higher the degree of leverage, the less capital they have at risk and the more they would be attracted by high-variance investments or policies in which they receive the full upside return.

In this light, the claim made by Professor Jensen and others that higher leverage is simply a bonding device by which management assures the capital market that it will subject itself to the discipline of the market's judgment misses a critical point: as leverage is increased, shareholders' attitudes do not remain static. Rather, shareholders would come to favor higher-risk policies and would pressure management in that direction. Consider, for example, how the board of directors of a corporation would behave if it were elected exclusively by, and were faithful only to, the desires of an electorate consisting only of warrant holders. Logically, warrant holders would prefer that course of action that increases the volatility of a stock and thus increases their chance of making a profit on their investment. Extreme as this example sounds, the shift toward higher leverage over the last two years has been dramatic,¹⁸¹ and with it should logically come increased shareholder pressure for management to accept higher risks.

180. See note 172 *supra*. It should be noted that this statement does not necessarily conflict with those writers who maintain that capital structure is irrelevant to the firm's value. Cf. Modigliani & Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958). The focus here is on the conflict between debtors and creditors, not the aggregate value of their claims.

181. Consider in this regard the striking fact that the equity base of the Bank of America is today only 2.8% of its total assets. See note 121 *supra*.

Of course, one answer to this hypothesis that increased leverage will produce an attitude of risk preference on the part of shareholders is that creditors will not sit by passively and permit higher risk to be imposed on them. Arguably, creditors will either contract with the corporation through such devices as bond indentures and loan agreements to restrict the risks that may be imposed on them, or they will charge higher interest, which at some point should chill the shareholders' desire for higher leverage. Although these contractual devices can restrict higher leverage, it is doubtful that they can restrict management from accepting higher risk once management finds it in its interest to do so. Debt/equity ratios are easily monitored, but, particularly in a large conglomerate, management's choice between competing investments or business strategies is not (at least not by creditors from their relatively remote vantage point).¹⁸² Recent experiences at such corporations as Continental Illinois, Baldwin-United, EPIC, Home State, or at the series of recently insolvent thrift and savings institutions in Maryland and Ohio remind us that these institutions, all of which were highly leveraged, did in fact shift additional and unbar-gained-for risks onto creditors.¹⁸³

D. *Assessing the Impact of Higher Risk:
Who Wins and Who Loses?*

1. *Shareholders*

From the preceding discussion it may seem that the clear winner in the trend toward higher leverage is the shareholder, for whom the takeover arguably maximizes value by forcing management to accept a higher level of risk in keeping with the shareholder's preferences. Yet, this conclusion is subject to one potentially important qualification. It is not all shareholders who want the corporation to accept a higher risk level than managers prefer, but only diversified ones. Some empirical evidence casts considerable doubt on whether most shareholders approach full diversification,¹⁸⁴ and institutional investors appear to account for less than half of all shareholdings.¹⁸⁵ Thus, there may

182. This point is acknowledged by Jensen & Meckling, *supra* note 28, who argue that therefore conglomerates should rely more heavily on equity financing, given the higher risks and monitoring costs that creditors would face. *Id.* at 338-40.

183. Until recently, regulatory supervision within the financial industry might have curbed this incentive to take excessive risk (from a social standpoint), but with deregulation there is little incentive for creditors to monitor adequately (given depository and other forms of governmental insurance). See notes 120-22 *supra* and accompanying text. Hence, a moral hazard problem arises, and these recent insolvencies tend to confirm this theory.

184. See note 40 *supra*.

185. See note 41 *supra*.

be a significant and unrecognized conflict between institutional shareholders, who do approximate full diversification, and other shareholders who do not. The latter group may logically occupy a position on the continuum somewhere between managers and diversified shareholders, depending on the size of their investment in the corporation and their degree of diversification.

Should we therefore be concerned about and seek to protect the undiversified shareholder? This conclusion does not necessarily follow. It remains a puzzle why these shareholders have failed to diversify. Arguably, some of them may actually be risk preferrers who do not seek the benefits of diversification. If so, these shareholders would hardly want restraints placed on leverage. Or, they may in fact be fully diversified, once their ownership of risky assets other than securities is considered. Finally, they may simply be commercially incompetent and thus not realize the ease with which full diversification could be achieved by investing in mutual funds. Only in the last case would paternalism seem justified, but it would be highly speculative to premise any reform proposals on the assumption that these investors are in the majority.

2. Creditors

Creditors represent an intermediate class that appears to have lost more than it has gained, although its long-term reaction may not yet be fully visible. Anecdotal evidence is now abundant that bondholders have recently been adversely affected by highly leveraged takeovers.¹⁸⁶ This evidence conflicts with earlier findings that bondholders typically either gained or suffered no loss in mergers.¹⁸⁷ The reason for this reversal seems intuitively obvious: while traditional synergistic mergers generally increase the firm's assets and hence the bondholders' security, the new generation of highly leveraged takeovers has had the opposite effect. The recent series of credit downgradings by Moody's and Standard & Poor's, which frequently have been the by-product of either takeovers or takeover-motivated defensive activity, also provides evidence that creditors may have less ability to monitor risk tak-

186. See *Bondholders Unitel*, *supra* note 133; Prokesch, *Merger Wave: How Stocks and Bonds Fare*, N.Y. Times, Jan. 7, 1986, at 1, col. 1 (citing recent examples and quoting securities industry experts that "[b]ondholders on both sides are often left holding the bag"); *Takeovers and Buyouts*, *supra* note 135, at 113 (viewing takeovers and buyouts as wealth transfers from bondholders to stockholders).

187. Earlier empirical studies had suggested that wealth transfers from bondholders to stockholders seldom occurred in mergers, but these studies predate the appearance of the bust-up takeover. See Asquith & Kim, *The Impact of Merger Bids on the Participating Firms' Security Holders*, 37 J. FIN. 1209 (1982).

ing by managements than neoclassical theory assumes.¹⁸⁸ Although economists have traditionally assumed that creditors can protect themselves adequately by imposing financial tests and covenants in bond and loan indentures,¹⁸⁹ the empirical evidence suggests that their confidence is unjustified because, contrary to the conventional wisdom, the trend is very much in the direction of eliminating most such covenants from bond indentures.¹⁹⁰ Various reasons can be advanced to explain why bond creditors sometime in the recent past abandoned contractual restrictions: possibly creditors simply assumed them unnecessary in the case of "Triple A" credit corporations because they perceived that managements did not desire to accept significant additional risk; possibly they found that the contracting process had proven too costly; possibly they concluded that there are simply too many ways in which the firm's level of risk could be increased that were simply not amenable to feasible contractual restrictions.¹⁹¹ In all likelihood, management can change its corporate strategy so as to accept more risk in a variety of low-visibility ways. That they have not typically done so in the past may reflect the basic managerial inclination toward risk aversion that this article has previously stressed. Yet, under shareholder pressure, this bias is being overcome, and, at least over the short run, creditors suffer as a result.

If creditor monitoring is more costly and less effective than traditional economic theory has assumed, what implications exist for the future? Essentially, if contractual protections fail, creditors face a choice between "voice" and "exit."¹⁹² Greater "voice" is obtainable

188. See notes 133-39 *supra* and accompanying text.

189. For a statement of the conventional view, see Smith & Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979) (arguing that there is an optimal set of financial covenants and restrictions for each company, which is reached through bargaining and market pricing).

190. See McDaniel, *supra* note 138, at 425-26 (reporting results of a survey of Fortune 100 corporations which finds that few corporations today include traditional or even related covenants in their indentures).

191. *Id.* at 428 ("In the real world, even a rough approximation of an optimal bond contract is out of the question.").

192. This exit/voice distinction is, of course, borrowed from A. HIRSCHMAN, *EXIT, VOICE, AND LOYALTY* (1970). Neoclassical economic theory has long claimed that only the residual claimants should possess voting rights, because unnecessary agency costs would arise if multiple groups shared the voting power. See Easterbrook & Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 405 (1983). Admittedly, creditors and stockholders have dissimilar preferences and a series of inconsistent voting choices is possible, but the claims made by Easterbrook and Fischel that a firm "is likely to self-destruct" in such an event seem overstated. *Id.* The real question is whether the firm's cost of capital will be lower under a system of creditor protections implemented through debt covenants in indentures and loan agreements or under a system that grants them voting rights. Delaware corporate law permits bondholders to have voting rights. See DEL. CODE ANN. tit. 8, § 221 (Supp. 1986). Historically, the former system has prevailed, but its relative efficiency may have derived from a set of managerial preferences that the takeover has

through the negotiation of voting rights in order that creditors could directly monitor management; a greater right to "exit" could arise if investors began to insist on shorter-term debt instruments, so that high-risk debt securities came to resemble commercial paper, which revolves regularly. The former route might vastly change the internal governance of corporations, while the latter would expose corporations to a new level of volatility. Until recently, neither development would have been conceivable, but in the interim massive wealth transfers have occurred from bondholders to stockholders. Contractual protections have not yet failed, but these alternatives are already visible.

3. *Employees*

Employees and managers constitute the best example of a class that has had to accept the imposition of higher risk. Many recent instances can be identified where corporations first leveraged up as a takeover defense and then followed this action with subsequent massive dismissals or compelled retirements of employees.¹⁹³ Another prevalent recent phenomenon has been the termination of pension plans or the transfer of "excess" funds from such plans back to the corporation, particularly as leveraged firms struggled to maintain liquidity.¹⁹⁴

In overview, very different evaluations of this trend are possible.

now disrupted. That is, growth maximization as a managerial aim tends to benefit creditors by giving them excess security, thus making it unnecessary to negotiate elaborate loan covenants.

193. See sources cited at notes 15 & 131 *supra*. The oil industry provides a particularly good illustration, because it is here that the takeover pressure has been the most dramatic. Annual reports for the 12 largest oil companies show that they had 124,000 fewer employees at the end of 1983 than at the end of 1981. The Chevron/Gulf combination resulted in a reduction of the combined entity's work force by 12% or about 10,000 jobs (and 2000 more were to be eliminated in the first half of 1985); Texaco planned to trim its work force by 26% during 1985. See Schmitt, *supra* note 15, at 15, col. 3. Some evidence also suggests that the cost savings from layoffs may sometimes approach on a capitalized basis the takeover premium. See note 293 *infra* and accompanying text.

194. Over the last five years, employers have terminated more than 700 pension plans and collected \$6.7 billion in "surplus" assets; \$3 billion was recaptured in 1984, equal to the three previous years and thus showing a rising tide. Probably the largest and best-known recent case involved United Airlines, which announced in 1985 that it intended to recapture over \$1 billion for general corporate purposes. See Farnsworth, *Washington Watch: Pension Plans' Surplus Assets*, N.Y. Times, Aug. 12, 1985, at D2, col. 1. As of August 28, 1985, \$3.1 billion had been recaptured during 1985, thus exceeding 1984. See Williams, *Raking in Billions From the Company Pension Plan*, N.Y. Times, Nov. 3, 1985, at F1, col. 2.

In United's case, the recapture was announced as a defensive move designed to thwart a raider, because the surplus assets were placed in a trust which could only be used to finance corporate expansion. See Byrne, *UAL Will Use Some of Unit's Pension Funds*, Wall St. J., June 11, 1985, at 2, col. 2. In other cases, the raiding of the pension fund's assets appears to have been designed to help finance future acquisitions. See *Pension Fund Shift Is Planned by FMC*, N.Y. Times, Nov. 8, 1985, at D4, col. 5.

Obviously, it can be said that these dismissals and plan terminations represent only the efficient pruning of surplus staff and redundant resources. There is probably some truth to this generalization, particularly given the earlier-noted tendency toward inefficient growth within large firms. On a macroeconomic level, the U.S. economy has long employed a substantially higher level of administrative and managerial personnel than other similar economies, and this tendency may be a symptom of organizational slack.¹⁹⁵

In some industries, particularly the oil industry, the recent take-over wave has probably only anticipated and hastened a shrinkage that developments in the product market and the gradual depletion of oil reserves would have eventually caused. In other industries, particularly the food and broadcasting industries, where some of the largest mergers of 1985 occurred, it is more difficult to find any revolution occurring in the product market, but employee reductions may reflect a general downsizing of corporate staffs incident to a trend away from excessive diversification. Yet, the efficiency of these staff reductions does not fully answer the critical normative issue. Should the expectations of these employees that they would have continuing employment in the absence of a financial crisis be seen as rising to the level of an "implicit contract"? This question will be deferred until Part III.

4. *The State*

Neoclassical theory sees the corporation as an exclusively private body. The state's corporations code is viewed as simply a model form contract that the state provides to simplify the contracting process and from which the parties are free to opt out by inserting specially tailored provisions in the corporation's certificate of incorporation.¹⁹⁶ Historically it is clear, however, that the corporation originated in the United States as a quasi-public body in which the state was often a very unsilent partner.¹⁹⁷ Yet, probably not since Adolf Berle's later writings has there been much of an attempt in the academic literature

195. "Administrative and managerial personnel" constituted 10.8% of total nonagrarian employment in the United States in 1980 as opposed to 3% in West Germany, 2.4% in Sweden, and 4.4% in Japan. See Green & Berry, *Taming the "Corpocracy": The Forces Behind White-Collar Layoffs*, N.Y. Times, Oct. 13, 1985, at F3, col. 1. This evidence is difficult to evaluate, but it is revealing to learn that the percentage of nonproduction workers as a percentage of total employment rose by more than 50% between 1947 and 1980. This rise coincides with the appearance and growth of the conglomerate and provides some ammunition for those who doubt that it has curbed the problem of organizational slack.

196. For a statement of this view, see R. POSNER, *ECONOMIC ANALYSIS OF LAW* 369-72 (3d ed. 1986).

197. See L. FRIEDMAN, *A HISTORY OF AMERICAN LAW* 188-201 (2d ed. 1985). Almost all colonial-era corporations in the United States were quasi-public in character: churches, charities, or cities and boroughs. Throughout the entire eighteenth century, corporate charters were

to view corporate law as other than an essentially private body of law.¹⁹⁸

What view then can be taken of the state's role that still treats the corporation as a private body essentially focused on wealth maximization? One answer is to view the state's role as that of an insurer for the losses that limited liability spares shareholders. Because costs do not disappear just because shareholders escape them, it follows that the state often bears these costs as, in effect, an ultimate residual risk bearer. At a minimum, the state's welfare rolls increase when corporations fail, and often the state winds up partially compensating tort creditors. This inevitable role of the state has been neglected, probably because significantly concentrated losses usually occurred only during recessionary periods. Also, the state's role has low visibility because the state does not in any formal sense guarantee the obligations of the firm; rather, it absorbs indirectly many of the losses initially experienced by the other constituencies that surround the firm. Axiomatically, if plants are closed and workers and managers are laid off in the aftermath of either a takeover or a defensive tactic that increases corporate leverage, much of the resulting costs will fall on the state, which typically will be required to pay increased welfare benefits and make other transfer payments. In the case of local communities, there may also be extensive firm-specific investments that the community has funded to create the infrastructure of social services that surround a major plant or corporate headquarters.¹⁹⁹ To be sure, the relationship is a symbiotic one, and the state or local community also benefits, but there is no reason to believe that the community should rationally be indifferent to the level of risk accepted by such a firm.

Once again, as with bond creditors, contractual restrictions could in theory protect the community's interest. But no such contracting

issued to only 335 businesses, and only seven of these were during the colonial period. *Id.* at 188-89.

198. See A. BERLE, *THE 20TH CENTURY CAPITALIST REVOLUTION* (1954). For a review of this literature, see Weiner, *The Berle-Dodd Dialogue on the Concept of the Corporation*, 64 COLUM. L. REV. 1458 (1964); Romano, *Metapolitics and Corporate Law Reform*, 36 STAN. L. REV. 923 (1984).

199. This trend is increasing as small towns now bid for major industrial plants by offering to install special improvements and to develop a surrounding infrastructure of schools and other social services. Such investment represents a form of firm-specific capital, even if it does not show on the firm's balance sheet. The recent negotiations surrounding General Motors' "Saturn" plant show this. See Ansberry & Sasaki, *Ohio Town Gives Look at Future for Site of GM's New Saturn Plant*, Wall St. J., Aug. 30, 1985, at 17, col. 3 (discussing GM's proposed plant at Spring Hill, Tennessee; Honda's plant at Marysville, Ohio; and Nissan's plant at Smyrna, Tennessee). Of course, local communities can negotiate, and even contract formally, with a large employer to protect their firm-specific capital, but in these negotiations they tend to be novices matched against a "repeat player" who sees that it is in a "buyer's market" full of communities eager to attract such employers.

process appears visible. Possibly this absence is explained by the often-intense intercommunity competition for corporate relocations, possibly because smaller governmental units tend not to be sophisticated "repeat players" (and so are overreached), or possibly for other reasons. For present purposes, the relevant contention is only that the state and local communities frequently stand in the position of a creditor or partial surety for the corporation.

III. THE MANAGERIAL LABOR MARKET: THE PROBLEM OF PROTECTING DEFERRED COMPENSATION

Implicit in much recent commentary about hostile takeovers has been a view of managers as the villain of the story. Their ability to shirk or consume excessive perquisites or otherwise overreach shareholders is seen as providing the rationale for the hostile takeover. True as it is to say that managers sometimes do all of these things, they also can be presented as the victims of the story. Threatened with loss of job security and expected deferred compensation in a volatile stock market in which few companies are not at some point rumored to be takeover targets, managers have been forced as a takeover defense to leverage up and accept a higher level of risk. They are thus left in the unenviable position of having "all their eggs in one basket," with the solvency of the basket suddenly placed in doubt. Standing alone, however, either of these accounts is unbalanced.

The simple neoclassical model of the firm sees the shareholder as the sole residual risk bearer. As this theory was given its standard synthesis by Frank Knight,²⁰⁰ the shareholder is seen as the critical actor, the risk-bearing entrepreneur who contracts for the services or capital of the other participants, agreeing to pay them a return governed by external markets while he, himself, retains whatever surplus, if any, remains once these fixed claims are paid. Because the shareholder faces the greatest variance in possible future returns, it is he who most needs to monitor the performance of the other participants,

200. See F. KNIGHT, *supra* note 29, at 279-80, 359. Knight viewed the shareholders as exercising the critical authority in selecting the manager of the firm; he does not appear to have focused on agency cost problems. Following Knight, neoclassical economics has seen the shareholders as the residual risk bearers, while others — managers, employees, creditors — are viewed as being guaranteed a contractual rate of return. Knight's theory has been extended by Alchian and Demsetz to explain why only the residual risk bearers should be the monitors of the firm. See Alchian and Demsetz, *supra* note 28. Only a monitor elected by those holding the residual claimants' interest in the firm, they argue, has an adequate incentive to prevent shirking. In this article's view, this form of analysis gives insufficient attention to the fact that managers bear residual risk along with shareholders, given their limited mobility in the managerial labor market, the prevalence of seniority-weighted salary structures, and the existence of firm-specific capital.

as any shirking or opportunistic behavior by them will reduce the return for which he has contracted.²⁰¹ From this perspective, it is understandable that typically only shareholders vote and that directors' fiduciary obligations run almost exclusively to their benefit.

Still, this model probably overstates the case for shareholder sovereignty. In particular, the assumption that managerial wages are subject to external market standards is subject to at least two serious objections: First, from the "implicit contract" perspective, managers may have traded off salary for employment stability.²⁰² Thus, if the firm fails, they may lose compensation for services already rendered. Second, managers face special problems in terms of safeguarding their investment in firm-specific human capital. Others have argued that this may give managers a legitimate interest in the nature of the firm's governance structure.²⁰³

Although lateral mobility is today increasing, the still-prevalent pattern is one under which new managers enter the firm at relatively low-level "ports of entry" and gradually move upward along steep seniority ladders.²⁰⁴ Compensation is deliberately arranged to reward seniority and thus to inhibit lateral mobility. This pattern of internal promotion and seniority-weighted compensation is thought to be in the firm's interest, both in order to encourage managers to invest in firm-specific human capital and to defer some portion of the manager's compensation for an ex post settling-up at which his contributions to the firm can be better assessed.²⁰⁵ That is, managers are asked to develop expertise that often only has value within a specific firm, not to the broader labor market, and to postpone the receipt of some income as a safeguard against opportunism.

These two objectives — the incentive to develop firm-specific capital and the safeguard of deferred compensation — are distinct, although each may be present to a greater or lesser degree in any given case. Firm-specific human capital consists not only of specialized training or knowledge, but also the ability to work within an existing corporate culture and organizational structure.²⁰⁶ For present pur-

201. Fama and Jensen argue that efficiency considerations dictate that the residual claimants have decision control, because this governance structure reduces monitoring costs. See Fama & Jensen, *supra* note 28, at 303.

202. See sources cited at note 62 *supra*.

203. See Williamson, *supra* note 103, at 632-33.

204. See note 43 *supra*.

205. See Knoeber, *supra* note 65, at 157-59, 162 (arguing that ex post compensation determinations are sometimes more efficient because they allow information relating to the success of an investment or project to be factored in).

206. See T. DEAL & A. KENNEDY, *supra* note 42.

poses, its existence implies that the senior manager may be left in an exposed position, because to the extent he has invested heavily in firm-specific human capital, he typically has little lateral mobility. As several recent writers, most notably Professors Aoki and Williamson, have pointed out,²⁰⁷ the manager's investment of human capital is thus at risk, because only over the course of a career will he receive the expected return that leads him to make this investment. If the firm is taken over, his investment may be lost, either because a different firm-specific expertise may now be necessary to operate within the acquiring firm, or because his position duplicates that of a similar manager within the acquiring firm (and hence he is likely to be replaced). Like the bondholder, the manager has arguably lost bargained-for security through a transaction to which he did not consent.

The desirability of deferring some portion of the manager's compensation is thought to rest on different grounds. Even in industries where firm-specific capital is not a significant factor, the use of deferred compensation reduces the incentive for the manager to shirk or consume excessive perquisites and makes it possible to factor into the amount of compensation information not currently available (such as the eventual success or failure of a long-term research or marketing project). But specifying the amount of deferred compensation is virtually impossible to do, given the scope of the relevant information and the number of future contingencies that need to be addressed. On these grounds, it has been argued that deferred compensation is best awarded by means of implicit contracts.²⁰⁸

Implicit contracts, of course, do not bind the bidder. Although it has reputational interests that would keep it from dealing with its own employees in an opportunistic fashion, it can credibly maintain that, as a stranger to the target, it never undertook any obligation to fulfill implicit agreements with its employees. Given the vulnerability of an implicit promise of deferred compensation, the corporation has essentially two alternatives: it can compensate the manager for this new level of risk through higher direct compensation, or it can "bond" its promise to pay deferred compensation. That is, the corporation can either pay a risk premium to all managers to reflect this loss of future employment security, or it can utilize bonding devices, such as the "golden parachute," which compensates only those who are in fact terminated. The latter approach has several advantages: first, it better responds to the problem of risk aversion, because paying managers a

207. See M. AOKI, *supra* note 29, at 25-26; Williamson, *supra* note 29, at 1207-09.

208. See Knoeber, *supra* note 65, at 157-59.

risk premium at the outset will not assure that they will not later still seek to block a takeover. Rather, they might rationally both accept the premium and still seek to oppose a takeover. Second, it retains the advantages of deferred compensation by creating a disincentive to lateral transfers for a higher current salary. Third, it avoids the necessity of determining what the appropriate risk premium should be and, of course, involves no net cash outlay if there is no takeover.

The case for the "golden parachute" as a bonding mechanism rests chiefly upon the impracticality of giving management more specific contractual protections and the undesirability of granting it specially weighted voting privileges.²⁰⁹ In the past, management had ample protections against the impairment of its implicit contract through its de facto control of the board of directors, but the advent of the hostile takeover has effectively shown the limitations of this form of contractual protection. In the future, devices such as the Employee Stock Ownership Plan ("ESOP") may give management similar security, but only at the cost of requiring the firm's entire labor force to become overinvested in its firm and thereby to incur increased risk-bearing costs.²¹⁰ In contrast, the attraction of the "golden parachute" is its simplicity. One need not calculate the precise amount of deferred compensation or firm-specific human capital that is to be protected because, as with other forms of surety bonds or liquidated damages provisions, the real need is for a provision that is reasonably related to, but not less than, the likely loss. So long as the manager cannot himself "pull the ripcord," greater precision is not truly necessary.

This sanguine assessment of the "golden parachute" will seem naive and uncritical to some. They will point to the undeniable examples of egregious overreaching by management or to the possibility that

209. A variety of techniques has recently been used to place weighted or "super-voting" stock in management's hands. In 1984, Coastal Corporation obtained shareholder authorization for a new class of shares having 100 votes per share, which it then distributed in a fashion that shifted voting power to its management. See Hector, *The Flap Over Super-Shares*, FORTUNE, Sept. 16, 1985, at 114. Another device has been to issue super-voting stock to all shareholders but to provide that these voting rights lapse on a transfer until the new holder has held them for defined period (say three years). This again denies the bidder the ability to obtain a voting majority in that period. Historically, the New York Stock Exchange has insisted as a condition of listing eligibility on the rule of "one share, one vote," but in 1985 it indicated that it was reconsidering this rule. See Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687 (1986).

210. The use of ESOPs has risen dramatically, but substantial issues of fairness also surround their use, because employees may be overreached by them. Note, *The False Promise of Worker Capitalism: Congress and the Leveraged Employee Stock Ownership Plan*, 95 YALE L.J. 148 (1985); see also notes 244-46 *infra* and accompanying text. The use of the "leveraged" ESOP as a takeover defense has also become common. See Simmons, Ward & Watson, *An ESOP Can Be an Effective Anti-Takeover Device*, Natl. L.J., June 30, 1986, at 25, col. 1 (discussing use in several recent takeover battles). In terms of this author's analysis, the fundamental problem with the ESOP is that it forces employees to invest in an undiversified portfolio.

"golden parachutes" can be used as a takeover defense, rather than as a means of cushioning the manager's exit.²¹¹ Although the law of fiduciary duties has until recently placed few meaningful limits on the board's discretion in this area,²¹² it does not follow from this evalua-

211. Some recent examples of "golden parachutes" do indeed seem extreme, but largely because of factors distinct from the dollar amounts in question. In connection with its leveraged buyout, Beatrice Cos. granted golden parachutes totalling \$23.5 million to six officers. One of these officers had been with the corporation for only thirteen months and yet received a \$2.7 million package; another, the chief executive officer, received a \$7 million package, even though he had emerged from retirement only seven months before. See Johnson & Morris, *Beatrice Cos. Grants Golden Parachutes Totalling \$23.5 Million to Six Officials*, Wall St. J., Nov. 25, 1985, at 4, col. 1. In neither such case would there appear to be much firm-specific capital at risk. Indeed, it has been estimated that Beatrice's chief executive would receive under his contract more than \$5000 for each hour that he had worked at Beatrice since emerging from retirement. See Greenhouse, *Golden Chutes Under Attack*, N.Y. Times, Dec. 10, 1985, at D2, col. 1. In another well-known case, Michel Bergerac, the former chairman of Revlon, received a \$35 million package consisting of severance pay and stock options. See Stevenson, *Decisions for Owner of Revlon*, N.Y. Times, Nov. 4, 1985, at D1, col. 3. Yet, in both cases these amounts were trivial in comparison to the total acquisition price (\$6.2 billion in the Beatrice buyout and \$1.74 billion for the Revlon acquisition). Similarly, when the fifty top officers of Allied and Signal received slightly over \$50 million in golden parachutes in connection with their merger, this amounted to only about 1% of the total merger price of \$5 billion. See *Allied-Signal Tie Proves Lucrative to Executives*, N.Y. Times, Aug. 13, 1985 at D2, col. 5.

Most commentators have doubted that "golden parachutes" are an effective takeover defense, as their cost has been estimated at less than one percent of the total cost of a takeover. See Morrison, *Those Executive Bailout Deals*, FORTUNE, Dec. 13, 1982, at 86.

Frequently, the manager's right to receive the special termination compensation specified in the "golden parachute" clause of his employment contract is triggered by a "change in control" of the corporation employing him; this means that the manager need not be terminated by the successful bidder but may voluntarily resign and collect the specified payment. For a fuller description of these clauses, see R. WINTER, M. STUMPF & G. HAWKINS, SHARK REPELLENTS AND GOLDEN PARACHUTES 425-28 (1983). One recent survey by Ward Howell International, Inc. of "Fortune 1000" corporations found that 21.8% of these contracts providing for a lump sum termination payment were triggered by their terms even if the employee resigned voluntarily. See Note, *Golden Parachutes and the Business Judgment Rule: Toward a Proper Standard of Review*, 94 YALE L.J. 909, 909 n.3 (1985).

212. Several recent cases have invalidated or granted preliminary injunctions against the exercise of "golden parachutes," especially when the officers could trigger the payment at their own election. In one of the most publicized of these cases, a Wisconsin appellate court ruled that any "golden parachute" without a mitigation or offset clause was unenforceable as against public policy. See *Koenings v. Joseph Schlitz Brewing Co.*, 123 Wis. 2d 490, 368 N.W.2d 690 (Ct. App. 1985). However, this decision was reversed by the Wisconsin Supreme Court, which found the principal issue to be the reasonableness of the stipulated damages clause and recognized the impact of a hostile takeover on employee morale as a factor that could be considered in this determination. *Koenings v. Joseph Schlitz Brewing Co.*, 126 Wis. 2d 349, 377 N.W.2d 593 (1985). *Koenings* frames the correct test in this author's judgment, but in determining whether the damages clause was reasonable a court should look not to the employee's existing salary but to the normal pattern of salary increase and deferred compensation that he would have anticipated. For other recent decisions, see *Minstar Acquiring Corp. v. AMF, Inc.*, 621 F. Supp. 1252 (S.D.N.Y. 1985) (preliminary injunction granted with respect to a rights plan under which severance benefits triggered by a change in control); *Weinberger v. Shumway*, No. 547586 (Super. Ct. San Diego County, Cal.) (preliminary injunction granted with respect to Allied-Signal merger payments to executives), cited in Moore, *Golden Parachutes Appearing Vulnerable*, Legal Times, Sept. 30, 1985, at 1, col. 1. Recent settlements also show that managers cannot rely on their "change of control" contracts as written. In *Weinberger*, the former executives of Signal Corporation agreed to a \$25 million reduction in benefits after a preliminary injunction was granted. See Greenhouse, *supra* note 211. Prior to these recent cases, there does not appear to have been a decision invalidating a "golden parachute" contract on the merits. See Note, *supra* note 211, at

tion that the current potential for abuse is serious. To the contrary, recent revisions in the tax law have accomplished what the common law never seemed able to achieve: the creation of a bright-line standard that few boards will be willing to cross. Under the current tax law, a corporate tax deduction is presumptively denied for "excess parachute payments"; these are defined as those that both (i) exceed three times the executive's average annual compensation over the preceding five years, and (ii) are contingent on a "change of control" (as defined).²¹³ In addition, a twenty percent excise tax must be paid by the recipient executive on "excess parachute payments." Whether this trebled salary standard is too low can reasonably be debated, but it clearly sets a ceiling that many boards will not lightly exceed, in part for fear of their own liability for waste of corporate assets.

In this light, although instances of overreaching will no doubt arise from time to time, the more pressing problem with managerial compensation may be the overly limited use of such contracts. Although such "change of control" contracts are now very common at senior managerial levels,²¹⁴ they appear to be relatively uncommon at middle management and staff levels. Yet, work force reductions after a takeover tend to fall most heavily on those occupying staff positions, both at senior and middle management levels, because these persons are essentially redundant if the bidder has similar personnel and their discharge does not threaten immediate operating performance.

Should we be concerned about unequal treatment within management's own ranks? One view would be that managers are not poverty-stricken waifs for whom a court should feel a paternal responsibility. A similar, equally cold-blooded response would be that because only the senior managerial staff that controls the corporation needs to be appeased in order to reduce opposition to takeovers, the need for protective severance compensation should also stop with this limited class of those who could mount effective opposition to the takeover. Still, if there is a social interest in encouraging investments in human capital, these views are short-sighted. The unique problem with human capital is that the usual market solutions for risky investments — *i.e.*, in-

909 n.6. Many commentators have argued that the business judgment rule would protect such agreements. *Id.* at 912 n.17.

213. See 26 U.S.C. §§ 280G, 4999 (Supp. II 1984). For a history and closer analysis of these new provisions, see Lear & Bagley, "Excess" Golden Parachute Payments Specially Taxed, *Nat. L.J.*, Nov. 4, 1985, at 15, col. 1.

214. According to Ward Howell's survey of "Fortune 1000" companies, 48% of such companies protected senior management with employment contracts, almost half of which contained "change of control" provisions. As of October 1984, 180 of 485 corporations surveyed from Standard and Poor's 500 list of companies had "change of control" provisions with some of their senior executives. See Lear & Bagley, *supra* note 213, at 15-16.

insurance or diversification — simply are not feasible. Moreover, any individual management that extended so unusual a form of severance compensation to its junior ranks would attract undesired visibility and likely produce shareholder discontent, thereby increasing its vulnerability to a takeover.

Ideally, a clearer legal standard is therefore needed that both protects shareholders from egregious wealth transfers in favor of managers and that also assures that any tax subsidy inherent in these payments is distributed broadly and not enjoyed exclusively by the most senior corporate officials. Here, a useful analogy is suggested by the federal law applicable to pension plans. As a precondition for favorable tax treatment, qualified pension plans may not “discriminate” in favor of “officers, shareholders or more highly compensated” employees.²¹⁵ Nondiscrimination does not, however, require that all be treated identically; rather, in a defined-contribution plan, an equivalent percentage contribution may be made on behalf of all salaried income above a specified level. Effectively, this means that the CEO’s pension may not be based on a higher percentage of his covered compensation than that of a lower-echelon plant manager. Consider now the consequences of generalizing this equality constraint by also making it a condition of the corporate tax deduction for “change of control” payments. The effect of such a proposal is to supply a floor that matches the ceiling of the “trebled salary” standard specified in current law. Such a rule would not require that “change of control” payments be made, but it would prevent senior management from protecting its interests to the exclusion of those at lower echelons. In effect, all managers would be placed on a similar footing. To be sure, it can be argued that junior managers neither have much firm-specific capital invested in the corporation nor have had significant compensation deferred, but other formulae — such as a seniority-based one with an intermediate cutoff level — can respond to this consideration and are equally acceptable on the conceptual level, which in theory demands only that any principle for the award of employment termination compensation be “nondiscriminatory.”

Although costly to shareholders, “change of control” severance compensation may well prove less expensive than the risk premium

215. See 26 U.S.C. § 401(a)(4)-(5) (1982). In substance, these sections require a qualified pension or profit-sharing plan not to discriminate, but they permit the contributions made on behalf of employees to “bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of such employees” and to exclude that portion of an employee’s compensation on which FICA payments are made. In effect, this permits an employer to make contributions on a percentage-of-salary basis, excluding that portion of an employee’s salary on which social security contributions must be paid.

that managers would demand once the "old" equilibrium in the executive labor market shifted because the "implicit contract" had been breached.²¹⁶ In addition, a nondiscrimination rule can be monitored at low cost (and by the Internal Revenue Service), thus sparing courts the need to determine substantive fairness in complex, fact-specific cases. This egalitarian rule would neither be a mandatory requirement (if senior management did not avail itself of "golden parachutes"), nor would it exclude other procedural safeguards (such as a requirement of shareholder approval). Indeed, a ratification requirement naturally follows once it is the entire managerial staff that receives this largess from the shareholders. Finally and perhaps most important, such a "golden rule" makes the golden parachute as politically palatable as the pension plan.

In rebuttal, various objections are predictable. First, it can be argued that the analogy just proposed between severance and pension benefits does not stand up under closer scrutiny, either because there is no tax subsidy involved in the case of the "golden parachute" or because the two kinds of payments are somehow qualitatively different. These arguments seem dubious. First, for employees having unvested pension or profit-sharing pension benefits, severance compensation may represent a payment that is largely in lieu of the tax-subsidized benefits forfeited on termination. Second, the underlying economic nature of the "golden parachute" is less certain than it first appears, with the result that there is arguably a tax subsidy being provided when the corporation deducts these payments. In overview, such payments can be viewed as part of the purchase price of the target, which is paid to obtain management's acquiescence. If, in fact, the bidder is purchasing the target management's consent, such a cost should logically be capitalized as part of the purchase price and amortized much like goodwill. Hence, no tax deduction need result. Of course, it would be too cynical to characterize all such payments as *de facto* bribes to management not to oppose the takeover. But, given these uncertainties as to the appropriate characterization, a legislative compromise seems the soundest answer. Thus, conditioning the corporate deductibility of "change in control" compensation upon the observance of a nondiscrimination constraint seems an appropriate price to

216. To date, employee termination payments do not appear to have exceeded one percent of the total cost of a takeover. See Morrison, *supra* note 211, at 86. Even in a case such as that of the Chevron-Gulf acquisition, where 10,000 employees were laid off, the cost of a three-year employment guarantee, subject to an offset for income received from other employment if the employee resigned voluntarily, would not exceed \$1 billion. High as this number sounds, it would still represent less than eight percent of the \$13.3 billion acquisition cost of that megatransaction.

charge when there is at least a prospect of a tax subsidy being awarded. Essentially, such a trade-off is analogous to the treatment accorded qualified pension plans by section 401 of the Internal Revenue Code. In both cases, the tax law would be striking a balance with respect to payments whose current deductibility would otherwise be debatable and difficult to assess in each individual case.

A second predictable objection to the proposed rule is that no reason is apparent to cover the managerial staff, but not lower-echelon workers. Why draw such a line? Here, the answer is simpler. First, lower-echelon employees seldom possess firm-specific capital, can generally resort to external markets, and are seldom promised deferred compensation. Second, the "implicit contract" theory can also be used to draw a line between the mere employee and the officer, because the former typically has an explicit contract — namely, the collective bargaining agreement. Finally, the line is not mandatory. All that it requires is equality within a defined class, and additional largess can be extended.

IV. REDEFINING THE LAW'S ROLE

This Part confronts a frankly speculative task: how should the perception of the modern corporation as a complex set of contracts among different constituencies affect substantive corporate law? This broad question will be approached in terms of three distinct subsidiary questions: (1) To what degree should the law of fiduciary duties permit directors to consider the interests of nonshareholder constituencies? (2) To what degree should the board be able to assist or favor a leveraged buyout organized by management in response to a hostile bid? (3) To what degree and for what reasons may state takeover statutes constitutionally restrict a bidder by seeking to regulate traditional areas of corporate governance?

A. *Fiduciary Duties Through the Prism of Implicit Contracting*

From a contractual perspective, one can argue that recent takeover developments have disrupted a prior system of implicit contracting and made possible involuntary wealth transfers from managers to shareholders. Although many managers would accept this controversial thesis, many shareholders almost certainly would not. This lack of consensus is predictable because an implicit contract is by definition an incomplete contract, one in which the expectations of the parties have never fully met. Thus, each side acts over an extended period on the basis of expectations that have never been formally accepted by the other, and the legal issue becomes how a court should respond when

asked to fill in a missing term that the parties never negotiated.²¹⁷ From management's perspective, this implicit contract had two key elements. First, managerial terminations were to be limited either to instances of demonstrated personal incompetence or occasions when impending insolvency threatened the viability of the firm as a whole.²¹⁸ Second, there was an expectation of an ex post settling-up so that managers who contributed disproportionately to the firm's welfare would be specially rewarded.

Yet, whatever the beliefs of managers, shareholders can respond that the board's loyalty must be to them and expectations of continuing employment do not therefore justify opposition to a takeover. Unquestionably, the Delaware Supreme Court's decision in *Revlon* supports such a position,²¹⁹ and among recent takeover decisions probably only the *Union Carbide* case reaches a clearly contrary result.²²⁰ Yet, even if opposition to a takeover cannot be justified under

217. Professors Easterbrook and Fischel have argued that the most sensible approach to this problem is to implement the fiduciary principle by asking what the parties would have rationally bargained for with respect to the unforeseen contingency. See Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 700-03 (1982). They then argue that the parties would bargain so as to maximize the aggregate gains without regard to their distribution. *Id.* at 711-15. For a critique, see Brudney, *supra* note 17, at 1408, 1415 n.31. Presumably, Professor Brudney would say that managers are to be held strictly to the preexisting corporate contract (*i.e.*, the corporate charter and bylaws), unless they possess explicit contractual rights in an employment agreement. For the general rules as to how a court should proceed when there is a "missing term" in a contract, see Farnsworth, *Disputes over Omissions in Contracts*, 68 COLUM. L. REV. 860 (1968).

218. Such an "implicit contract" of continuing employment has been described by students of the labor market as a widely prevalent phenomenon. See Azariadis, *supra* note 62; see also M. AOKI, *supra* note 29, at 5, 7, 70, for a discussion of implicit bargaining. On the managerial level, Gordon Donaldson reports that the senior managements he studied identified with their managerial staffs and saw themselves as a collective managerial team whose interests lay in minimizing the power of other constituencies, such as labor or the shareholders. See G. DONALDSON, *supra* note 53, at 155-56. For a strong statement of such a management/employee bond by the chief executive officer who is chairman of the Business Roundtable's Corporate Governance Committee, see Lueck, *Building a New Empire Out of Paper*, N.Y. Times, Aug. 12, 1984, at F6, col. 4 (quoting Andrew Sigler of Champion International).

219. See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182-84, 184 n.16 (Del. 1986) (rejecting arguments that Revlon board could consider interests of non-shareholder constituencies in determining disposition of Revlon's assets).

220. See *GAF Corp. v. Union Carbide Corp.*, 624 F. Supp. 1016, 1019-20 (S.D.N.Y. 1985): The protection of loyal employees, including managers, of the organization is not anathema in the Courthouse. To be compared are the situations in which similar protection to the well-being and security of employees, pensioners, and loyal members of management is regularly accorded when a business is moved or substantially liquidated; they are similarly directly affected by unfriendly raids on control. . . . A corporation with a perceived threat of dismemberment of large divisions of the enterprise, employing thousands of employees, owes substantial regard for their pension benefits and, in the case of loyal management, severance benefits.

Judge Pollack then concluded that the board's fiduciary responsibilities required it to "deal fairly and even-handedly with both the protection of investors, on the one hand, and the legitimate concerns and interests of employees and management of a corporation who service the interests of investors, on the other." 624 F. Supp. at 1020. Whatever a policy of "even-handedness" means, Judge Pollack did not have to explore these issues in depth because the defensive measure

common law principles, it does not follow that the idea of implicit contracts has no legal relevance. This article's answer is that it can support a policy of premium sharing, under which the board can seek to direct a substantial portion of the aggregate takeover gains to employees in order to prevent an involuntary wealth transfer from employees to shareholders. In this view, the missing term that a court may read into the corporate charter is not a promise of continuing employment but rather an agreement that both sides authorized the board of directors to undertake an ex post settling-up on any liquidation or sale of the firm.

But how does one get to this result in more conventional legal terminology, which does not recognize the concept of implicit contracts? Under the standard theory, when a contractual term is missing, the court may insert that term which it believes rational parties would have agreed upon had they focused on it.²²¹ Here, the term that was allegedly not focused upon is managerial compensation in the event of a takeover, and the most logical answer is that the parties would have approved a generous managerial right to exit as in their mutual interest. Why? A utilitarian answer is that it is difficult to believe that shareholders would not want to offer managers a relatively cheap inducement not to oppose a lucrative offer to shareholders, which management can often effectively block. That is, at a time when takeover premiums average around eighty percent in some surveys and when the total cost of even the most generous "golden parachute" compensation arrangements has been below one percent of the total acquisition cost of the takeover,²²² it is almost inconceivable that shareholders would not give up one percent of the total price in order to obtain an eighty percent premium. The cost of a strict fiduciary

at issue in *Union Carbide* — a financial restructuring — only anticipated what the bidder would have done if successful. A more specific standard is suggested later in the text at notes 240-47 *infra*.

221. See Farnsworth, *supra* note 217. The Easterbrook and Fischel thesis is that the parties to the corporate contract would bargain to maximize the total gain, regardless of its distribution among them; thus, they claim, when a court is confronted with an apparent "missing term" in the corporate relationship of shareholders and managers it should attempt to reconstruct this hypothetical bargaining process and determine what term would lead to the greatest enhancement of aggregate value. Professor Brudney has replied that this form of bargaining is indeterminate and that the burden under traditional principles should be on the party seeking protection from this "implied" term. See discussion at note 217 *supra*. In the final analysis, as takeovers have now become frequent and indeed pervasive, it seems to torture words to believe that any term is "missing," because the contingency is now clearly foreseen by all. Yet, the term is "missing" precisely because both sides saw it as an issue better resolved through ex post settling-up than through advance specification. The real issue becomes the degree of deference the court should give to the board's judgment to award seemingly very generous "change of control" compensation. Here, courts are at present differing. See note 212 *supra*.

222. See Morrison, *supra* note 211.

rule that prohibited such compensation might be to make shareholders worse off on an ex ante basis by encouraging managerial resistance.

An alternative route to the same end position may be doctrinally simpler. Under this latter approach, one focuses not on what the parties would have done, but on what they have done — *i.e.*, create a fiduciary relationship. They have done so precisely because a complete contractual specification of the respective rights of the parties was impractical. The best analogy here might be to the use of the term “reasonable” in a contract. Inherently, the use of such a term means that the parties preferred to rely on an ex post evaluation of conduct because they found it too difficult or costly to define the permissible or prohibited conduct to their satisfaction in advance. Put simply, an ex post determination by the board, subject to judicial review for reasonableness, often may be more efficient than attempts to draft a more elaborate, but still inevitably incomplete, contract, because the entitlement of any manager to deferred compensation cannot be precisely defined in advance. The board of directors can thus be viewed as a body that both sides intended to mediate this conflict. Except for decisions such as *Revlon*,²²³ modern case law has recognized the directors’ authority to make reasonable provision for nonshareholder constituencies.²²⁴ This “rule of reason” approach is appropriate and should be extended to the takeover context precisely because the parties could not anticipate all future contingencies. The bottom line is, however, that this broader view of both the directors’ and the court’s role legitimizes an ex post settling-up on a simpler doctrinal basis.

Because this analysis may sound too abstract to have specific appli-

223. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

224. For example, the American Law Institute’s *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* § 2.01 (Tent. Draft No. 2, 1984) provides that whether or not corporate profit and shareholder gain are thereby enhanced, the corporation, in the conduct of its business

...
(b) may take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business, and

(c) may devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.

In principle, both clauses (b) and (c) could be cited to justify “change of control” consideration or the creation of an ESOP after a takeover bid had commenced. *See id.* § 2.01 illustration 14 (permitting purchase of annuity for employee without retirement income on firm’s liquidation). The key issues are “reasonableness” under subparagraph (c), and whether an “ethical” principle is discernible under subparagraph (b). Although one can dispute whether “change of control” payments can be analogized to other efforts by a corporation to protect its employees, some courts have already drawn this analogy. *See GAF Corp. v. Union Carbide Corp.*, 624 F. Supp. 1016, 1019-20 (S.D.N.Y. 1985). In *GAF*, the court suggests that the fiduciary position of the board required it to consider the interests of its employees in a bust-up takeover. 624 F. Supp. at 1019-20. This may overstate the prior precedents, but it does suggest that the concept of the fiduciary relationship is more open-ended and multi-faceted than either the positions of Professor Brudney or Professors Easterbrook and Fischel describe it to be.

cations, it is useful to contrast it with the recent position taken by the Delaware Supreme Court in *Revlon*, where the court said that once a takeover became inevitable the duty of directors "changed" to that of "auctioneers charged with getting the best price for the stockholders at a sale of the corporation."²²⁵ But why does the nature of the directors' duty change in this "end game" context? Presumably, the *Revlon* court's assumption is that no need exists for the target's board to consider the interests of nonshareholder constituencies at this stage, because their goodwill can no longer benefit a corporation that is soon to be sold or liquidated. Put differently, the court's premise is that longer-term considerations, such as employee morale, creditor expectations, and community relations, have no relevance when there no longer is a long term.

The accuracy of this assumption, however, depends entirely on whether we adopt an *ex ante* or *ex post* perspective. When viewed from the moment before liquidation it may be true that the attitude of these other constituencies is irrelevant, but it is far from self-evident that this is the appropriate vantage point from which to analyze the issue. The alternative is an *ex ante* perspective, which looks at the same question as of an earlier moment well before any specific takeover bid materialized. From this perspective, it is easier to recognize that takeovers threaten the interests of employees and other constituencies, and that therefore some protection must be accorded in order to attract, hold, and motivate employees. Operationally the board can do this in a variety of ways, either through contractual protections (including the "golden parachute"), or by preferring a bidder who will minimize the losses to nonshareholder constituencies. The latter is necessarily an *ex post* tactic that can only be implemented once the threat has materialized (although it can be anticipated *ex ante*), while the former can be adopted before any specific threat materializes, but is most sensibly adopted at the last possible moment when the greatest information is available. Therefore, unless some reason can be given why it is an inappropriate form of protection, *Revlon's* timing distinction seems an oversimplified approach which ignores that some forms of protection are best adopted *ex post*.

Rather than focus on the time at which the board's decision is made (*i.e.*, before or after the moment at which a corporate sale becomes inevitable), the sounder rule would accord equivalent capacity to the board but review the reasonableness of its efforts in either case

225. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986). For a similar statement, see *Edelman v. Fruehauf Corp.*, 798 F.2d 882, 886-87 (6th Cir. 1986). But see *GAF Corp. v. Union Carbide Corp.*, 624 F. Supp. 1016, 1019-20 (S.D.N.Y. 1985).

to provide for nonshareholder constituencies. Such a rule neither assumes that the board's task is to balance different constituencies nor denies that its fundamental responsibility is to the shareholders. Rather, it simply recognizes that the "end game" is foreseeable, and therefore it permits the board to bond itself to share some reasonable portion of the expected takeover premium with these other constituencies. The next section will outline a more specific application of such a policy's proposed operation.

B. *The Leveraged Buyout Defense: How Much Preference Is Too Much?*

Once a hostile bid is made, a variety of factors today often makes a leveraged buyout by target management the most viable (and sometimes the only) alternative.²²⁶ Time and information constraints that inhibit other bidders are less critical to a "white knight LBO," because by definition it has more knowledge about the target and thus faces less uncertainty. Although other bidders may hesitate to compete with each other²²⁷ or may find that the resources of the leading junk-bond investment banking firms have already been committed to the first bidder,²²⁸ an LBO bidder can usually find alternative sources of financing that can be arranged by specialists in this field.²²⁹ Indeed,

226. See Lipton, *In Defense of White Knight LBOs*, Legal Times, Aug. 18, 1986, at 1, 9 ("Indeed, in many current takeover situations an LBO is the only alternative to a bootstrap, bust-up, junk-bond takeover by a corporate raider at a price that does not reflect the full value of the target."). Martin Lipton points out that in the recent battles for Revlon and SCM no alternative bidder appeared other than the LBO bidder. Thus, it can be argued that the law should encourage competitive bids by LBOs to facilitate a value-maximizing auction. Still, in other recent cases, such as that involving Anderson Clayton, rival bidders (Ralston Purina and Quaker Oats) did materialize in response to a management-initiated LBO. See Bleakley, *Quaker Stars in Wall Street Soap*, N.Y. Times, Oct. 26, 1986, at F1, col. 4.

227. Professor William Carney has advanced the thesis that a "sunk cost" problem deters the second bidder, because it knows that the first bidder will disregard its own transaction costs in determining whether to top the second bidder's higher offer. Because rational bidders wish to avoid games where both sides will continue to raise the bid in order to recoup their initial investment, the second bidder will bid only if it receives favored treatment (usually in the form of a lockup). See Carney, *Two-Tier Tender Offers and Shark Repellents*, 4 MIDLAND CORP. FIN. J. 48, 50 (1986). Carney's position derives from work by the economist Martin Shubik on the economics of auctions. See Shubik, *The Dollar Auction Game: A Paradox in Noncooperative Behavior and Escalation*, 15 J. CONFLICT RESOLUTION 109 (1971). This theory tends to overlook the fact, however, that many, and probably most, hostile bidders will have purchased shares in the open market before commencing a hostile tender offer and can thus profit on their resale to the winning bidder (with the result that the second bidder should not be deterred). Still, the inability of the target under recent case law to grant inducements to the second bidder when it is an LBO bidder could preclude some auctions that are in the shareholders' interest.

228. Martin Lipton argues that "corporate raiders rarely compete with each other"; he suggests one reason may be that there is "only one source of junk bond financing for these raids." Lipton, *supra* note 226, at 9.

229. Well-known specialized firms, such as Forstman Little & Co., or Kohlberg, Kravis, Roberts & Co., concentrate almost exclusively on leveraged buyouts, and they and other firms,

the most interesting organizational innovation in the takeover field over recent years has probably been the new alliance between target managements and major investment banking houses to structure leveraged buyouts in which they participate as joint equity venturers.²³⁰ In effect, different specializations are combined — the operational skills of target management and the financial resources and abilities of the investment bankers — to form a streamlined, special-purpose bidder that has comparative advantages over the traditional third-party white knight, both because it “in-houses” the required management skills without also owning unnecessary assets (whose operational problems might divert managerial time), and because it possesses substantially more proprietary, nonpublic information about the target. From a public law perspective, the LBO usually involves a lesser degree of leverage and may minimize other social and economic distortions.²³¹ On most policy grounds, the LBO seems the preferred white knight, one whose general availability implies that there will usually be a second bidder to maximize value for shareholders.

Yet, in an unbroken string of recent decisions courts have invalidated corporate actions taken to favor the LBO bidder and have called into serious question the viability of this defense in a competitive bidding context. In *Revlon*²³² and *Hanson Trust*,²³³ the courts enjoined lockups of assets; in *Fruehauf*,²³⁴ the court enjoined financial assistance given by the target to the LBO bidder; and in *Anderson Clay-*

such as Merrill Lynch & Co., have frequently offered to top third-party bids through arranging a leveraged buyout. See *Edelman v. Fruehauf Corp.*, 798 F.2d 882 (6th Cir. 1986) (Merrill Lynch buyout); *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (buyout offer by Kohlberg, Kravis for Trans Union Corporation withdrawn).

230. See Sterngold, *Wall St. Buys Into the Action*, N.Y. Times, June 19, 1986, at D1, col. 3 (noting that Morgan Stanley and The First Boston Corporation had each recently been involved as equity participants in nine buyouts; Merrill Lynch & Co. in six; and Shearson Lehman Brothers, Inc. in three).

231. For example, the degree of leverage in white knight LBOs has typically been less than in hostile bust-up takeovers. The most aggressive use of leverage to date is that attempted by Turner Broadcasting in its unsuccessful bid for CBS. It would have caused the resulting company to have “had a debt-to-equity ratio in excess of 18 to 1 (in contrast to CBS’ pre-takeover ratio of .4 to 1).” M. Salter & W. Weinhold, *Corporate Takeovers: Financial Boom or Organizational Bust?* 13 (rev. ed. Jan. 30, 1986) (paper prepared for Columbia Law School Conference on Takeovers and Contests for Corporate Control). No LBO has approached this level, nor is it likely to need to, because of the accessibility of financing sources other than the junk-bond market. Similarly, although substantial layoffs have followed LBOs, it seems a fair estimate that they tended to be less dramatic and severe than in hostile bust-up takeovers. See G. DONALDSON, *supra* note 53, at 155-56 (finding that managers tend to identify with the interests of employees). Exceptions to this rule may, however, exist. See note 244 *infra*.

232. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

233. *Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264 (2d Cir. 1986).

234. *Edelman v. Fruehauf Corp.*, 798 F.2d 882 (6th Cir. 1986).

ton,²³⁵ the Delaware Chancery Court ruled that a "coercive" self-tender at a premium not effectively higher than the hostile offer would not be permitted. In sum, these decisions reveal courts to be responding primarily to the doctrinal concern that the LBO is a form of self-dealing. Hence, any inducement given by the target corporation to a bidder in which its senior management holds a substantial equity interest is subjected to close judicial scrutiny. This attitude contrasts sharply with the permissiveness generally shown by courts to lockups granted to third-party bidders.²³⁶

Although these decisions are each understandable on their facts, the logic underlying their analysis seems overbroad, because it suggests that assistance is impermissible even when the monetary value of the inducement is less than the increment in the bid that it produces. For example, if the target gives \$50 million in financial assistance to an LBO in which management is interested, and this bidder then tops the prior bid of the hostile bidder by offering \$75 million more on an aggregate basis for the same securities, it is obvious that on a net basis shareholders are at least initially better off. Of course, the problem with this simple objective rule that the assistance given by the target should be less than the enhancement obtained over the prior bid is that such assistance may sometimes close down the auction. For example, if the white knight LBO tops the prior bid by offering additional consideration of \$51 million in return for financial assistance (or a stock or asset lockup at a bargain price) from the target corporation worth \$50 million, shareholders may not be better off if this assistance precludes the first bidder from continuing the auction or chills its incentive to offer a higher price. Essentially, this analysis seems to have been accepted by the *Revlon* and *Fruehauf* courts, which each in effect ruled that the target directors must conduct a fair and neutral auction.²³⁷

235. *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,942 (Del. Ch. Sept. 18, 1986).

236. *See, e.g., Treadway Cos. v. Care Corp.*, 638 F.2d 357 (2d Cir. 1980) (approving target board's issuance of shares to white knight to dilute 34% stake of hostile insurgent).

237. In *Fruehauf*, the target corporation would have paid approximately \$30 million to Merrill Lynch for loan commitments, advisory fees, and for a "break-up fee" that Merrill Lynch would receive if the deal did not go through. *See* 798 F.2d at 885. The target "also made available \$100 million of corporate funds for management's use in the purchase of shares." 798 F.2d at 885. This latter action was largely equivalent to a self-tender by Fruehauf itself for its own shares, except that a self-tender by Fruehauf would have reduced the equity base equally for both bidders while purchases by the LBO bidder tilted the contest toward it. The LBO bid was at a price \$4.50 (or roughly 10%) above the pre-tender share price offered by the hostile bidder. 798 F.2d at 884. Given that the price increase was nearly 10% and that the total transaction was over \$800 million, it is not clear to this author that the \$30 million paid to Merrill Lynch was contrary to the shareholders' best interests.

Logically, however, several objections can be made to this assertion that inducements are bad because of their propensity to foreclose the auction. First, at least in theory, bidders can protect themselves by pricing their bid at a preemptive level, instead of seeking a low premium takeover. Rational bidders would understand that a low premium bid could be topped and would raise their initial bids. Arguably, a rule that allowed management to halt the auction after it topped the hostile bidder's first bid might even have desirable incentive effects on future bidders, leading them to disdain "low ball" takeover bids. Second, the LBO is potentially the highest bidder in many instances, both because its principals have a sunk investment in human capital and are competing for the right to protect that investment and because they face less uncertainty over what information they will discover after the acquisition. Third, the LBO bid may be less coercive than the alternative of a target self-tender, which is allowed.²³⁸ Most important, financial assistance to the LBO may be less an unfair thumb on the scales than a thumb that evens the scales, because the hostile bidder has probably made pre-tender open-market stock purchases at a cheaper price and can thus purchase control more cheaply. Neutrality is thus not a self-evident virtue, and a "fair" auction may require some inducements to the second bidder.

Still, one need not contend for a rule that permits the target to close down the auction, because the most likely form of assistance — namely, financial assistance through the payment of commitment fees and "bust-up" fees — should generally have little chilling effect on the first bidder's incentive to raise its bid in response. Bust-up fees seem especially innocuous because they are paid only if the LBO bid is in fact topped.²³⁹ Although the sale of a "crown jewel" asset or a stock lockup may sometimes halt the auction,²⁴⁰ financial assistance will

238. In *Fruehauf*, a self-tender by the target would have been preferable because it would have equally facilitated the hostile bidder's ability to acquire control. In general, however, there has been a vigorous debate about the legitimacy of corporate self-tenders as a defensive tactic. Compare Bradley & Rosenzweig, *Defensive Stock Repurchases*, 99 HARV. L. REV. 1377 (1986), with Gordon & Kornhauser, *Takeover Defense Tactics: A Comment on Two Models*, 96 YALE L.J. 295 (1986). See also *AC Acquisitions Corp. v. Anderson Clayton & Co.*, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,942 (Del. Ch. Sept. 18, 1986) (finding self-tender coercive where at same approximate price as tender by hostile bidder).

239. Nonetheless, in *Fruehauf*, the Sixth Circuit ruled that commitment fees to the investment bankers might be paid only in instances "where the neutrality and objectivity of the Board is clearly present." *Edelman v. Fruehauf Corp.*, 798 F.2d 882, 887 (6th Cir. 1986). It is highly questionable whether a target board has ever been truly neutral in a takeover contest, but the apparent implication of this statement is to permit such assistance only to a third-party white knight and not to an LBO white knight. Such a broad statement overlooks that the playing field was already made unlevel by the pre-tender purchases of the first bidder; this factor should justify some financial assistance by the target to the LBO in order to induce a value-maximizing auction.

240. The sale of a "crown jewel," or the granting of an option with respect to it, to a white

only have this effect when its amount reduces the target's value in the first bidder's eyes to a level approaching the last bid made. Such payments can largely be prohibited by a rule that requires them to be less than the bid increase made by the LBO bidder and comparable to fees paid in arms-length, third-party transactions.

The real paradox about a rule precluding corporate assistance to a management LBO is that it seems contradictory to apply a strict scrutiny standard to such assistance and then view severance compensation permissively. Both involve corporate wealth transfers that can be valued in monetary terms, and both can be defended as instances of premium sharing. Indeed, the one key difference is that in the case of financial assistance to the LBO, it is more feasible to place an objective limit on such assistance by requiring that it be reasonably related to the size of the price increment that it produces over the prior hostile bid. Some decisions, such as *Union Carbide*, would permit the board to resist a takeover on grounds of employee welfare.²⁴¹ It seems a considerably more modest and sensible position to authorize the board to place a modest thumb on the scales in favoring a preferred bidder, if (1) this preference can be reasonably related to the interest of non-shareholder constituencies and (2) the amount of the assistance is of an order of magnitude that would be upheld in the case of severance compensation for management and employees as a whole. This last limitation — that the magnitude of the assistance be limited by what would be reasonable to grant in the way of severance compensation — also suggests that such assistance will seldom shut down the auction.²⁴² If this is true, then the identity of the recipient of the assistance — whether it is an employee in the form of a “golden parachute” or an employee-owned bidder through the payment of commitment fees — is less important than the fact that in the latter instance the

knight should dissuade a financially motivated bidder only if it is at a bargain price that thereby lowers the target's value or, in the case of an option, limits its value to the hostile bidder. The Second Circuit has recognized that “the very purpose of an asset option in a takeover context is to give the optionee a bargain . . .” *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 276 (2d Cir. 1986). If the sale or option were not at a discount, the same disparity between asset and stock values might prevail as originally motivated the bust-up bid, and the newly cash-rich target would be even more attractive to the bidder. However, there may be some “synergistically motivated” bidders who would not pursue the contest further if a specific asset were sold, because they have no interest in making a purely financial investment in the target.

241. See *GAF Corp. v. Union Carbide Corp.*, 624 F. Supp. 1016, 1019-20 (S.D.N.Y. 1985).

242. Certainly, the grant of severance compensation has not been seen as an effective takeover defensive tactic, and thus payments on a similar scale to investment bankers should also have little effect. For example, in a transaction of over \$800 million (as *Fruehauf* was), a payment of \$30 million for fees would not normally have a decisive effect on the bidding, unless the hostile bidder had already made nearly its maximum offer. In contrast, the \$100 million contributed by *Fruehauf* should be seen as unreasonable, both as excessive by itself and because similar purchases by *Fruehauf* would not have halted the auction.

benefit to shareholders in the form of a raised bid is more demonstrable.

Of course, a more general reason for according some preference to the LBO is that its victory may minimize the economic losses, dislocation, and trauma experienced by nonshareholder constituencies. Those who accept the pure disciplinary thesis that takeovers cause good managers to replace bad managers will dispute this claimed advantage because they view managerial displacement as a positive good.²⁴³ As this article has earlier contended, however, takeovers have less to do with upgrading management than with changing its behavior (particularly with regard to "free cash flow," debt levels, and investment risk).

In candor, one cannot idealize LBOs as the protector of non-shareholder constituencies without a closer look at the abuses associated with their actual operation.²⁴⁴ Sometimes they can result in far worse discrimination against employees than if the hostile bidder assumed control. A classic illustration of such abuse involved a recent proposed buyout at Scott & Fetzer, in which an ESOP was effectively asked to finance management's acquisition of the firm.²⁴⁵ Ultimately, the proposed transaction was thwarted by Labor Department intervention, but by most accounts the federal government can only exercise a limited oversight of the most substantial and visible transactions.²⁴⁶ Because management's control over corporate assets, and in particular over the pension fund or ESOP, creates serious risks of exploitation in leveraged buyouts, close judicial scrutiny of LBO

243. Indeed, Judge Easterbrook has recently stated that job security is undesirable because it diminishes the employee's incentive to perform. *Kumpf v. Steinhaus*, 779 F.2d 1323, 1326 (7th Cir. 1985). This analysis is clearly too simple.

244. In some management-initiated restructurings which have been undertaken as a takeover defense, the layoffs have been nearly as severe as those that hostile bidders intend. Owens-Corning Fiberglas Corporation, for example, recently announced plans to cut its work force of 28,000 by about 13,000 in connection with a restructuring that would pay nearly \$1.5 billion to shareholders in a recapitalization. See Fowler, *Huge Cutbacks Set at Owens-Corning*, N.Y. Times, Oct. 17, 1986, at D3, col. 5.

245. In the proposed \$574 million Scott & Fetzer buyout, the firm's public shareholders were to be bought out jointly by an ESOP and a holding company owned by management and certain other investors. Essentially, after giving effect to dilutive warrants issued to the lender, the ESOP would buy 41% of the company for \$182 million, while management's holding company would get 29% for \$15 million. See Sheppard, *Let Them Eat Crumbs: Leveraged ESOPs and ERISA*, 32 TAX NOTES, 848, 850 (1986). Moreover, after dilution, the ESOP's \$182 million contribution would have a book value of only \$155.8 million. The United States Department of Labor intervened to block this transaction in 1986, and eventually a third party bought out Scott & Fetzer. In effect, employees were being asked to borrow \$182 million from a third-party lender to finance an LBO by the company's management that promised the employees a negative rate of return. *Id.* at 850.

246. See *id.* at 850 (quoting experts in the field on the frequent use of ESOPs to effect leveraged buyouts in smaller transactions and the infrequency of Labor Department intervention).

transactions seems necessary — but such scrutiny should focus less on protecting shareholders than on guarding the interests of these other constituencies who are the most vulnerable to involuntary wealth transfers in buyouts.²⁴⁷

Where then are we left? At worst, a policy of allowing financial assistance to an LBO may sometimes result in a value-maximizing auction being prematurely terminated. Conversely, a policy of precluding assistance may prevent the auction from beginning (chiefly because the first bidder has probably made a pre-tender acquisition of shares in the open market at a cheaper price). Thus framed, the trade-off may appear indeterminate, but if some specific tactics are barred, judicial balancing seems adequate to deal with those not precluded. In particular, prohibiting asset or stock lockups by the target to the LBO bidder seems justifiable, because such tactics are usually intended to foreclose the auction and inevitably result in disputes that are difficult to resolve about the magnitude of the bargain or advantage conferred. In contrast, it seems an overreaction to extend this prophylactic rule even further to bar financial assistance, which can be objectively measured and which essentially restores the balance between the bidders.

To operationalize these comments, consider a \$1 billion LBO bid made in response to an earlier \$800 million hostile bid (each for either 100% of the target's stock or some equivalent percentage). In such a context, a decision by the target board to grant \$50 million in financial assistance to the LBO bidder (either for commitment fees or as an equity investment) in return for the latter's commitment to make a substantially higher bid neither injures shareholders nor is likely to prevent a determined bidder from continuing the auction. Once it is determined that such assistance is not out of proportion (either in terms of the bid increment — here \$200 million — or the level of severance compensation that might have been paid to the managerial team as a whole), the remaining question should be whether the board has reasonably determined that such assistance will broadly benefit nonshareholder constituencies. Although the answer to this question is hardly self-evident, a court could consider the views of these constituencies, who recently have become increasingly vocal (and sometimes decisive) in corporate control contests.²⁴⁸ If a court were to find that

247. Most empirical evidence has found that shareholders reap handsome profits in buyouts that are comparable to the rates of return to target shareholders in tender offers. See, e.g., DeAngelo, DeAngelo & Rice, *Going Private: Minority Freezeouts and Stockholder Wealth*, 27 J.L. & ECON. 367 (1984) (finding average premiums in buyout transactions competitive with those in third-party tender offers); Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730 (1985).

248. The best example of the new involvement of nonshareholder constituencies in corporate control contests emerged in the recent contest between Carl Icahn and Texas Air Corporation for

these constituencies would benefit from the LBO's victory, this finding should justify permitting the target's board to place a thumb on the scales, at least to the extent that any financial assistance provided by the target fell within the earlier-discussed ranges.

C. *The Commerce Clause and the Permissible Scope of State Regulation: An Externality Analysis*

This article has earlier suggested that recent developments in the technology of takeovers have disrupted the relationships among the various contracting constituencies in the modern public corporation, exposing some to the prospect of serious loss. In the past, in similar transitional contexts when a market has undergone rapid change, states have often turned to regulation in order to cushion the shock or compensate for losses.²⁴⁹ Not surprisingly, the takeover context has recently been the subject of considerable state legislation, some of which has been clearly aimed at protecting the interests of non-shareholder constituencies.²⁵⁰ Although the wisdom and efficacy of these legislative efforts can be debated, the more important legal issue is their constitutional validity. Recent federal court decisions invalidating state takeover statutes have raised the question of whether the commerce clause and the Williams Act leave any legitimate role for state regulation of takeovers.²⁵¹ With the Supreme Court's forthcom-

control of TWA. Effectively, the unions shifted the balance of advantage to Carl Icahn, notwithstanding the TWA board's initial preference for Texas Air, because of the unions' distaste for Texas Air's labor record. See Salpukas, *The Long Fight For TWA: Unions Decided the Winner*, N.Y. Times, Aug. 31, 1985, at 1, col. 5.

249. For a critique of these regulatory efforts to ease transitions, see Kaplow, *supra* note 16. In this author's judgment, however, the market solutions on which Professor Kaplow would rely — chiefly insurance and diversification — are not feasible with respect to human capital.

250. See, e.g., HAW. REV. STAT. §§ 417E-1 to -15 (1976 & Supp. 1982); IDAHO CODE §§ 30-1501 to -1514 (1980 & Supp. 1986); IND. CODE ANN. §§ 23-2-3.1-0.5 to -11 (West Supp. 1986); MD. CORPS. & ASSNS. CODE §§ 3-601 to 3-603 (1985 & Supp. 1985); MINN. STAT. ANN. §§ 302A.011, .449, .671 (West 1985 & Supp. 1985); MO. ANN. STAT. §§ 409.500-.565 (Vernon 1979 & Supp. 1986); N.Y. BUS. CORP. LAW §§ 912, 1600-1613 (McKinney 1986 & Supp. Apr. 1986); OHIO REV. CODE ANN. § 1701.831 (Anderson 1985); OKLA. STAT. tit. 71, §§ 451-462 (Supp. 1985); TENN. CODE ANN. §§ 48-5-101 to -.114 (1984); UTAH CODE ANN. §§ 61-5-1 to -14 (Supp. 1986); VA. CODE ANN. §§ 13.1-528 to -541 (1985); WIS. STAT. §§ 552.01-.25 (1984). For reviews of these statutes, see Warren, *Developments in State Takeover Regulation: MITE and Its Aftermath*, 40 BUS. LAW. 671 (1985); Note, *Second Generation State Takeover Legislation: Maryland Takes a New Tack*, 83 MICH. L. REV. 433 (1984).

251. See *Dynamics Corp. of America v. CTS Corp.*, 794 F.2d 250 (7th Cir.) (invalidating Indiana statute), *prob. juris. noted*, 107 S. Ct. 258 (1986); *Fleet Aerospace Corp. v. Holderman*, 796 F.2d 135 (6th Cir. 1986) (invalidating Ohio statute), *appeal filed sub nom. Ohio v. Fleet Aerospace Corp.*, 55 U.S.L.W. 3175 (Sept. 2, 1986); *Terry v. Yamashita*, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,845 (D. Hawaii 1986) (Hawaii statute); *Icahn v. Blunt*, 612 F. Supp. 1400 (W.D. Mo. 1985) (Missouri statute); *APL Limited Partnership v. Van Dusen Air, Inc.*, 622 F. Supp. 1216 (D. Minn. 1985) (Minnesota statute).

ing review of decisions invalidating the Ohio and Indiana statutes,²⁵² some resolution of this issue is in prospect. This section will argue that the standard legal analysis is likely to lead to the wrong resolution and that the deeper issues involved require that we begin with a clearer understanding of what a corporation is. Once the corporation is properly understood, the firm/market distinction that the conventional analysis now draws becomes largely untenable, and thus an alternative standard must be formulated.

At bottom, the conflict the Court must resolve is between different visions of the corporation separately enunciated by the same Justice in *Santa Fe Industries v. Green*²⁵³ and in *Edgar v. MITE Corp.*²⁵⁴ Taken together, these two decisions assume that a clear, stable line can be drawn between the firm and the market. In *Santa Fe Industries*, the Court upheld Delaware's short-form merger statute against the claim that it was preempted by the federal securities laws.²⁵⁵ In so doing, the Court announced that corporations were creatures of state law and broadly affirmed the legitimacy of state regulation of corporate governance. Conversely, in *Edgar* the Court largely withdrew the market for corporate control from state regulation. A majority found the Illinois takeover statute at issue there to be invalid under the test of *Pike v. Bruce Church, Inc.*,²⁵⁶ which it read to apply even to a nondiscriminatory state statute. According to *Edgar*, the *Pike* test requires that "when a state statute regulates interstate commerce indirectly, the burden imposed on that commerce must not be excessive in relation to the local interest served by the statute."²⁵⁷ Applying this balancing test, the Court found there was no legitimate interest served by the Illinois statute's extraterritorial application, because "the State has no legitimate interest in protecting nonresident shareholders."²⁵⁸ In addition, because the Court construed the statute as regulating only market transactions among shareholders, it concluded that the statute could not be defended as a regulation of internal corporate governance.²⁵⁹

252. *CTS*, 794 F.2d 250; *Fleet Aerospace*, 796 F.2d 135.

253. 430 U.S. 462 (1977) (White, J.).

254. 457 U.S. 624 (1982) (White, J.).

255. 430 U.S. at 479.

256. 397 U.S. 137 (1970); see also *Minnesota v. Clover Leaf Creamery Co.*, 449 U.S. 456, 471 (1981).

257. 457 U.S. at 643.

258. 457 U.S. at 644. On this point, see also *CTS*, 794 F.2d at 263; *Fleet Aerospace Corp. v. Holderman*, 637 F. Supp. 742, 763-64 (S.D. Ohio 1986), *aff'd.*, 796 F.2d 135 (6th Cir. 1986), *appeal filed sub nom. Ohio v. Fleet Aerospace Corp.*, 55 U.S.L.W. 3175 (Sept. 2, 1986).

259. Justice White wrote that tender offers were transactions between stockholders and purchasers and thus "do not themselves implicate the internal affairs of the target company." 457

In response to *Edgar's* problematic distinction between corporate governance and market regulation, a number of states quickly revised their earlier takeover statutes by eliminating their extraterritorial application and couching them as aspects of substantive state regulation of corporate governance.²⁶⁰ As a result, this "second generation" of state takeover statutes has exploited traditional areas of corporate law, such as shareholder voting,²⁶¹ the appraisal remedy,²⁶² and mergers,²⁶³ in order to regulate takeovers. Both the Indiana and Ohio statutes now before the Supreme Court are examples of "control share acquisitions statutes," which condition the right of an acquirer to vote shares obtained in excess of specified thresholds upon a majority vote of "disinterested" shareholders approving such acquisition.²⁶⁴ Because this form of statute effectively conditions transactions between nonresident buyers and sellers in other jurisdictions upon a majority shareholder vote, it has much the same impact as the statute invalidated in *Edgar*, even though it typically applies only to corporations incorporated within the jurisdiction. In order to distinguish *Edgar*, the draftsman of the Indiana statute was careful not to forbid the acquisition of shares above the specified level; rather, the statute simply cancels the voting rights of these shares in the hands of such a holder, unless and until there is a requisite "disinterested" vote.²⁶⁵ Although voting rights would seemingly fall within the traditional scope of inter-

U.S. at 645; see also *APL Ltd. Partnership v. Van Dusen Air, Inc.*, 622 F. Supp. 1216, 1223-24 (D. Minn. 1985); *Fleet Aerospace Corp.*, 637 F. Supp. at 762 (noting that this distinction between regulating shareholders and regulating the corporation itself is "so fundamental that it cannot be disregarded").

260. The Indiana, New York, Virginia, and Wisconsin statutes cited at note 250 *supra* reach only corporations incorporated under each state's laws (and in some cases having certain other minimum contacts, such as a specified level of assets or shareholders within the state).

261. See, e.g., HAW. REV. STAT. §§ 416-171, 172 (1985); IND. CODE §§ 23-1-42-1 to -11 (West Supp. 1986); OHIO REV. CODE ANN. § 1701.831 (Anderson 1985) (all requiring a majority shareholder vote as a condition to voting shares acquired in a tender offer or other "controlling shares acquisition").

262. See, e.g., ME. REV. STAT. ANN. tit. 13-A § 910 (giving individual shareholders redemption rights on occurrence of majority share acquisition and certain other triggering events); 15 PA. CONS. STAT. ANN. § 1910 (Purdon Supp. 1986) (same).

263. IND. CODE ANN. § 23-1-43-18(a) (West 1986); KY. REV. STAT. ANN. § 271A.397 (Michie/Bobbs-Merrill Supp. 1986); MO. ANN. STAT. § 351.459 (Vernon Supp. 1987); N.Y. BUS. CORP. LAW § 912 (McKinney Supp. 1986) (all forbidding second-step mergers for five years following any tender offer that did not receive prior approval from target's board).

264. See note 261 *supra*. Each of the Hawaii, Indiana, Ohio, Minnesota, and Missouri Control Share Acquisition statutes have been struck down on the grounds that they burdened interstate commerce. See cases cited at note 251 *supra*.

265. Under the Indiana statute, once an acquirer purchases 20% of the voting stock of a covered firm and files a requisite disclosure statement, management has fifty days within which to hold a special shareholders' meeting to consider whether the acquirer should have voting rights. A decision to award such voting rights requires majority votes both of all shares and of all "disinterested" shares, a term that excludes both the acquirer and members of management. IND. CODE ANN. § 23-1-42-9(b) (West Supp. 1986). If the acquirer does not request the conven-

nal corporate governance, Judge Posner in *Dynamics Corp. of America v. CTS Corp.* nonetheless rejected as "transparent" this attempt to bury the antitakeover regulation deep within the Indiana corporations code.²⁶⁶ Still, however "transparent" the Indiana statute is thought to be, the basic issue remains: can a sound body of corporate jurisprudence distinguish in a principled manner regulation of the market from the substantive corporate law that regulates intrafirm behavior?

Valiant efforts will undoubtedly be made by others to draw such a line. Yet, the line-drawing problem is rendered intractable by the fact that virtually any aspect of corporate law can be distorted and manipulated to chill takeovers. Take, for example, a seemingly remote and unrelated body of corporate law, such as that applicable to directors. It is not difficult to exploit even the prosaic legal rules in this area by providing, hypothetically, that all directors shall serve five-year terms and are not removable except for cause. If one is to pierce this formalistic veil and look to substance, one is easily led to focus on legislative intent (as Judge Posner did),²⁶⁷ and this inquiry quickly leads into well-known and much-debated difficulties. Put simply, courts are notoriously reluctant to discern an improper legislative intent, particularly in the commerce clause area.²⁶⁸

Yet, unless we look to legislative intent, it may seem that we are

ing of such a special meeting or if the vote is unfavorable, the target corporation is authorized to redeem the shares at their "fair value." See IND. CODE ANN. § 23-1-42-11(a) (West Supp. 1986).

266. 794 F.2d at 261 ("Cleverly drafted though the statute is to skirt judicial holdings that forbid states to delay tender offers beyond the period required by the Williams Act, the cleverness is fairly transparent.").

267. 794 F.2d at 264 ("[I]n this case the effect on the interstate market in securities and corporate control is direct, intended, and substantial; it is not merely the incidental effect of a general regulation of internal corporate governance.").

268. For a thorough discussion of these problems, see Ely, *Legislative and Administrative Motivation in Constitutional Law*, 79 YALE L.J. 1205 (1970). Professor Gunther has noted that the Supreme Court is "reluctant to ascribe improper purposes and motivations to challenged laws in commerce clause cases." See G. GUNTHER, *CONSTITUTIONAL LAW* 277 (11th ed. 1985). For a recent case that may exemplify this reluctance, see *Exxon Corp. v. Maryland*, 437 U.S. 117 (1978).

Some critics believe that the Supreme Court should and does consider legislative purpose in commerce clause cases. Professor Regan argues, for example, that the Court's principal dormant commerce clause decisions have been "concerned exclusively with preventing states from engaging in purposeful economic protectionism." Regan, *The Supreme Court and State Protectionism: Making Sense of the Dormant Commerce Clause*, 84 MICH. L. REV. 1091, 1092 (1986). Despite strenuous efforts to string the many beads of commerce clause case law on the single thread of legislative purpose, Professor Regan is nonetheless compelled to admit that *Edgar v. MITE Corp.*, 457 U.S. 624 (1982), stands apart from all other cases. He dismisses *MITE* as a case that "stands for no doctrine at all; it stands only for a particular result." Regan, *supra*, at 1279. This is singularly unhelpful as a means of understanding a context to which the Court must return and whose economic significance overshadows the standard "movement-of-goods" cases that he addresses, in which typically only municipal ordinances are at issue. Another explanation for the result in *MITE* that he offers — namely that *MITE* involved an impermissible attempt at extra-territorial legislation — has no future application when the "second generation" of takeover

compelled to impose the lowest common denominator among the fifty states as the constitutional baseline, at least when the challenged provision affects takeovers. For example, Delaware requires only a fifty percent shareholder vote to approve a merger, while New York employs a two-thirds minimum.²⁶⁹ Although a higher vote is a relative barrier to a takeover, the New York statute was never intended to have this effect because it predates the appearance of the takeover and was in fact a liberalization of the common law rule that once required unanimous consent for a merger.²⁷⁰ While an intent test would seemingly spare the New York statute, which did not seek to discriminate or chill nonresident shareholders' capacity to sell their shares, the use of intent as the principal test produces disparities among effectively equivalent statutes, depending on the visibility of their underlying legislative motivations. More generally, an intent-focused inquiry places courts in an uncomfortable position, particularly once a predictable third generation of statutes appears that mask their intent behind a variety of pretexts, some of which may be very difficult to distinguish from legitimate forms of experimentation in a federal system.²⁷¹ Undeniably, the easiest course for an overworked Supreme Court would be to duck the commerce clause issue and decide *CTS* simply on a statutory preemption analysis under the Williams Act. This approach

statutes comes before the Court, because these statutes typically apply only to corporations incorporated within the jurisdiction.

Of course, one could seek to resolve these "second generation" cases by determining the legislature's motives. But these motives are often multiple and complex. For example, does a belief that takeovers interfere with long-range corporate planning, *see* note 279 *infra*, amount to discriminatory protectionism? If it does not, as I believe, does this legitimate motive entitle a state to prevent shareholders across the nation from receiving or accepting a tender offer from an out-of-state bidder? This conclusion would seem to follow if the only issue to be considered is whether the purpose was "discriminatory," but precisely for that reason I believe that a balancing approach is preferable. Because state corporation law is to an extent always extraterritorial in its application to nonresident shareholders, the question should be whether the same benefits could be realized by less drastic means. *See* text at note 273 *infra*. A "purpose"-focused inquiry tends to subordinate the extraterritorial impact of the challenged statute, which in the case of corporate law should be an important consideration even when the challenged statute has a legitimate basis.

269. Compare N.Y. BUS. CORP. LAW § 903 (McKinney Supp. 1986), with DEL. CODE ANN. tit. 8 § 251(c) (1983).

270. For a comprehensive review of the evolution of the law from the early rule that a merger required unanimous shareholder approval, *see* Weiss, *The Law of Take Out Mergers: A Historical Perspective*, 56 N.Y.U. L. REV. 624 (1981).

271. Prior to *CTS*, nothing in the Constitution seemed to bar a state from adopting a codetermination system of corporate governance for domestic corporations similar to the European model, under which labor representatives must serve on the corporate board. While such a system has few, if any, adherents in the United States, it would make a takeover very hard to consummate if the labor representatives on the target's board were opposed to the takeover. After Judge Posner's decision in *CTS*, however, it is arguable that such a statute interferes with the mobility of corporate assets and so offends the commerce clause. The result of such a position is in effect to federalize state corporation law by precluding new departures.

will, however, only postpone the commerce clause issue until a later day.

If neither *Edgar* nor *Santa Fe Industries* is to swallow the other, a compromise standard must be found. In fact, such a compromise position has long been recognized and was curiously ignored by Judge Posner in *CTS*. In *Dean Milk Co. v. City of Madison*,²⁷² the Court announced a test for commerce clause analysis to which it has regularly returned: when a statute or regulation has a valid local goal, but also gives rise to a high risk of discrimination, the state must bear the burden of showing that no "reasonable and adequate alternatives are available."²⁷³ Not only does such a less restrictive alternative test minimize the need for judicial inquiry into motive by instead properly focusing on effect, but, more important, it respects the central values of federalism that underlie *Santa Fe Industries*. It allows states to regulate corporate behavior to realize legitimate local goals, but requires that any burden on the national market be justified by showing that less drastic measures were not available. However, to apply this intermediate test to state takeover statutes, one must first answer two preliminary questions: (1) Is there a legitimate local goal that justifies regulation? (2) What alternatives are available that are less sweeping or burdensome on the national market?

Answering the first of these questions also shows why a firm/market distinction fails as a means by which to reconcile *Santa Fe Industries* with *Edgar*. When the Court said in *Edgar* that a state had no interest in regulating so as to protect nonresident shareholders,²⁷⁴ it implicitly assumed that the purpose of regulation was to protect shareholders and not others. Today, it is evident from the face of some recent statutes that the purpose of the regulation is to protect employees and local communities. Pennsylvania and a few other states now require that the directors as an aspect of their fiduciary duties consider the interests of nonshareholder constituencies.²⁷⁵ A recent New York statute that delays for five years any merger or equivalent transaction following a hostile acquisition of control was similarly premised on legislative findings about the need to protect local communities and

272. 340 U.S. 349 (1951). Professor Gunther notes that *Dean Milk* "is the most frequently cited case for introducing judicial inquiry into 'reasonable nondiscriminatory alternatives.'" G. GUNTHER, *supra* note 268, at 278. But see Regan, *supra* note 268, for a critique of the balancing approach.

273. 340 U.S. at 354.

274. 457 U.S. at 644 ("While protecting local investors is plainly a legitimate state objective, the State has no legitimate interest in protecting nonresident shareholders.").

275. See, e.g., ILL. ANN. STAT. ch. 32 § 8.85 (Smith-Hurd Supp. 1986); OHIO REV. CODE ANN. § 1701.59 (Anderson 1985); 15 PA. CONS. STAT. ANN. § 1408.B3 (Purdon Supp. 1986) (all authorizing or requiring directors to consider interests of groups other than shareholders).

employees.²⁷⁶ If we adopt Judge Posner's test in *CTS* that condemns any use of corporate law whose effect on the market for corporate control is "direct, intended, and substantial,"²⁷⁷ then these statutes would seemingly fail. Yet, impractical as these statutes may currently be,²⁷⁸ they still express legitimate state aims, quite distinguishable from attempts to hold local industries captive.²⁷⁹ Under *Dean Milk*, a balancing analysis should evaluate these statutes by considering whether other, less drastic alternatives were available.

The existence of nonshareholder constituencies also points up the economic fallacy in attempts to rest much weight on a firm/market distinction. In economic terms, the public corporation does not exist apart from markets. Rather, it is by definition the intersection of multiple markets. From the "nexus of contracts" perspective of modern economic theory, the corporation is to be seen not as an entity separate from the market, but as the equilibrium position reached by the negotiations of creditors, managers, suppliers, and shareholders as the residual claimants.²⁸⁰ In this view, the corporation consists of a set of contracts among participants in the equity, credit, and labor markets.

276. See N.Y. BUS. CORP. LAW § 912 (McKinney 1986). In adopting a package of takeover regulating proposals, including section 912, the New York legislature found that "such disclosure . . . includes information that is of particular interest to shareholders who reside in this state in assessing the impact of a proposed takeover bid on the employees and communities that would be affected." See N.Y. BUS. CORP. LAW § 1612 historical note (McKinney 1986); see also note 279 *infra*.

277. 794 F.2d at 264.

278. The New York statute which precludes a merger for five years after a hostile tender offer also restricts most forms of self-dealing between the acquirer and the target corporation that would produce an equivalent result. However, it does not address substantial dividends that do not formally liquidate the firm but that reduce it to a shell. Hence, this technique would remain available to a bidder who could acquire a very high percentage of the stock (say 90% or more) in the open market, then oust the incumbent board, and structure the functional equivalent of a liquidation. The specific transactions forbidden are listed in N.Y. BUS. CORP. LAW § 912(a)(5) (McKinney 1986).

279. Governor Cuomo's counsel, Evan Davis, who drafted the New York bill, has described its overall aim as "to encourage an atmosphere in which corporations can consider long-term issues." Carroll, *Cuomo Bill Offered on Takeovers*, N.Y. Times, Oct. 31, 1985, at D1, col. 6, D4, col. 3. For those who believe the commerce clause invalidates only state legislation having a discriminatory purpose, see Regan, *supra* note 268, such a justification, whose premise is widely shared within the business community, might alone serve to uphold the statute. Although it is debatable whether takeovers do in fact impede long-term planning as popularly believed, see Pound, Lehn & Jarrell, *supra* note 173, this judgment seems within the range of rational legislative choice to which a court would normally be expected to defer. Under a balancing approach, however, such a legislative judgment could not justify suppression of takeovers, but it could provide a sufficient local benefit in my view to uphold a measure that seeks to foster a more optimal spacing out of corporate control contests. See note 175 *supra*. For example, a state statute that authorized a charter provision limiting tender offers to periodic intervals (hypothetically, only during a six-month period every four years) should be sustainable against a commerce clause attack.

280. See Jensen & Meckling, *supra* note 28, at 311.

Each of these markets is in turn affected by changes in the other markets that produce at least a temporary disequilibrium.

Of course, if the firm does represent the confluence of multiple markets, some might argue that all these markets are beyond state regulation.²⁸¹ Hence, only federal law might be permitted to correct any imbalance that arose among them. Still, this argument trips over a critical irony. In a 1985 decision, *Schreiber v. Burlington Northern, Inc.*,²⁸² the Court essentially declared that the Williams Act was simply a disclosure statute, which was empty of any substantive content other than as expressly provided to regulate the procedural aspects of tender offers. *Schreiber's* reasoning was largely based on the need for deference to state regulation, and the decision thus follows faithfully in the footsteps of *Sante Fe Industries*. As a result, if the Court were to follow Judge Posner's reasoning in *CTS*, the Court would have emptied in the short space of two years both state and federal law of most of their substantive content with respect to takeover regulation. While some economists might applaud this result as appropriately "deregulatory," it is doctrinally indefensible to trim the federal statute by deferring to state law and then emasculate the state's power in deference to the federal government's control over interstate commerce.

The assertion that the interests of nonshareholder constituencies can qualify as a benefit to be balanced against the burden on interstate commerce encounters, however, at least two difficulties that need to be squarely faced. First, not all states can raise such a claim. Delaware, for example, could not seek to ground an antitakeover statute on this justification when the only contact it has with the corporation is the naked fact of incorporation. This is, however, just as it should be, and those states, such as New York, that have raised this justification have expressly required more contacts than simply the fact of incorporation.²⁸³ Second, it may be claimed that the asserted "benefit" amounts to nothing more than thinly disguised protectionism that is designed to prevent plant closings and relocations. In an extreme case this may be correct, but a balancing test can certainly deal with extreme cases.

281. To be sure, it is an open question whether the internal labor market within the firm is sufficiently within interstate commerce as to raise issues about the negative impact of the commerce clause. More realistically, the same issues tend to surface as preemption questions because federal law already regulates each of these markets through statutes, including the National Labor Relations Act, the federal securities laws, ERISA, and the Federal Reserve's margin rules. Preemption is a topic beyond the scope of this article. *But see* note 284 *infra*.

282. 472 U.S. 1 (1985).

283. *See* N.Y. BUS. CORP. LAW § 912(a)(13) (McKinney 1986) (defining "resident domestic corporation" as a corporation incorporated in New York and having "its principal executive offices and significant business operations located in this state . . . and . . . at least ten percent of its voting stock owned beneficially by residents of this state").

Moreover, the burden imposed on interstate commerce by existing statutes seems mild in comparison to the growing number of plant relocation statutes that require notice and severance pay to employees.²⁸⁴ So long as these relocation statutes are nondiscriminatory on their face and do not indirectly preclude relocation, they seem sustainable under the traditional balancing approach used in commerce clause adjudication.²⁸⁵ If they are constitutional, it follows a fortiori that statutes such as those adopted in New York and Pennsylvania, which are far milder in effect because they neither preclude relocations nor impose any financial obligation or penalty, should pass constitutional muster.

Assuming that a valid benefit can be asserted, the next question becomes whether less restrictive alternatives to recent takeover statutes are available. Arguably, statutes such as that of New York restricting post-tender mergers and liquidations²⁸⁶ are themselves a less drastic alternative to plant relocation statutes and similar measures. More important, there is always a less restrictive alternative to a mandatory statute: namely, a permissive statute that authorizes a shareholder-approved charter provision having the same substantive terms. Although the latter enabling statute may appear also to constitute state action, a considerable body of case law in related contexts suggests that charter amendments adopted pursuant to such a statute will be seen as voluntary private action, which the shareholders have ratified as in their own best interest.²⁸⁷ This public/private distinction should be given great weight in a balancing analysis under the com-

284. See Note, *NLRA Preemption of State and Local Plant Relocation Laws*, 86 COLUM. L. REV. 407, 407 n.6 (1986) (noting six such statutes enacted by states, plus some municipal ordinances). As many as forty states appear to be considering such legislation. See Lewin, *Workers' Rights In a Plant Closing Tested*, N.Y. Times, July 19, 1984, at D1, col. 4. The Supreme Court has granted certiorari in a case that will test this preemption issue. See *Director of Bureau of Labor Standards v. Fort Halifax Packing Co.*, 510 A.2d 1054 (Me. 1986), *prob. juris. noted sub nom. Fort Halifax Packing Co. v. Coyne*, 107 S. Ct. 430 (1986).

285. As Judge Posner noted in *CTS*, "[t]he commerce clause does not allow states to prevent corporations from moving assets and employees to other states." 794 F.2d at 264. Protectionism in the form of requiring goods or services to be produced within the state is also an invalid goal. See *Foster-Fountain Packing Co. v. Haydel*, 278 U.S. 1 (1928). However, plant relocation statutes that require only notice and severance pay that is reasonably related to the employees' past salary do not necessarily have this effect. Thus, their burden can be balanced against their benefits under fairly tolerant standards. Admittedly, a court may look to either a statute's effect or its purpose in determining that it represents discriminatory protectionism. See *Minnesota v. Clover Leaf Creamery Co.*, 449 U.S. 456, 471 n.15 (1981). But if the effect is modest and the application applies equally to intrastate relocations, a balancing test should uphold such a statute. See, e.g., *Dean Milk Co. v. City of Madison*, 340 U.S. 349 (1951); *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970); see also G. GUNTHER, *supra* note 268, at 276-78. Whether such a statute can survive a preemption-based attack is, however, another issue. See note 284 *supra*.

286. See note 276 *supra*.

287. For cases that recognize that private action taken pursuant to general state enabling authority does not amount to state action, see *Blum v. Yaretsky*, 457 U.S. 991, 1002-12 (1982);

merce clause, because it is presumptively logical to find that a benefit to shareholders exists that outweighs any burden on their own ability to trade in interstate commerce when the restraint is a self-restraint. In contrast, the reverse inference should be drawn from a mandatory statute that imposes an identical restraint by fiat, because shareholders should be presumed to be willing to adopt voluntarily any beneficial self-restraint. Indeed, management has every incentive to propose such amendments if it believes shareholders will approve them, and thus no obstacle requiring mandatory legislation to achieve the goal of shareholder wealth maximization is apparent. Although it is possible that shareholders can be overreached by management-proposed amendments, much commentary has suggested that there are in fact benefits to be gained from collective action by shareholders to adopt "shark repellents."²⁸⁸ Hence, even on policy grounds, no presumption against private action seems justified.

Nonetheless, this public/private or voluntary/mandatory distinction has been largely overlooked by both the courts and the SEC.²⁸⁹ It has, however, been expressly articulated in a recent draft by the Reporters to the American Law Institute's Corporate Governance Project.²⁹⁰ This distinction has constitutional relevance, because an

Rendell-Baker v. Kohn, 457 U.S. 830, 837-43 (1982); Flagg Bros. v. Brooks, 436 U.S. 149, 164-66 (1978); Moose Lodge No. 107 v. Irvis, 407 U.S. 163, 171-77 (1972).

288. See, e.g., Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1695 (1985); Carney, *Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties*, 1983 AM. B. FOUND. RES. J. 341, 349-53.

289. In its recent *Concept Release on Takeovers and Contests for Corporate Control*, Exchange Act Release No. 34-23486, 51 Fed. Reg. 28,096 (Aug. 5, 1986), the Securities and Exchange Commission stated:

The Williams Act and the Commission's tender offer rules currently operate as rules of general applicability with no provision for exemptions or modifications by stockholder or director action. Tender offers are thus conducted in accordance with uniform rules, and all participants are equally subject to regulations that Congress and the Commission have determined to be in the public interest.

Id. at 28,101. Although the release next suggests that there should be an opportunity for shareholders to adopt "self-governance exemptions," the above analysis seems an overstatement of existing law. No obstacle is apparent in the Williams Act, for example, to a shareholder-approved charter amendment that precludes partial tender offers (by, for example, denying voting rights to shares so acquired or prospectively restricting alienability), although the Williams Act would clearly not permit a state statute to preclude partial bids. For example, the clearest case of permissible private action would arise if a group of shareholders entered into a stockholders' agreement whereby they agreed not to tender unless an equivalent bid was made to all of them for all of their shares. If such private action precluding a partial bid is valid, the next question is why a similar private agreement cannot be set forth in the corporate charter. See note 290 *infra*.

290. See AMERICAN LAW INSTITUTE, *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* § 6.02 reporter's note 6, at 83-84 (Advisory Group Draft No. 7, 1986) (criticizing the SEC Concepts Release for failing to recognize that the Williams Act does not restrict private shareholder action that is intended to restrict or regulate takeover bids); see also *Data Probe Acquisition Corp. v. Datatab, Inc.*, 722 F.2d 1, 4-5 (2d Cir. 1983) (imposition of substantive obligations in a tender offer contest is an unwarranted extension of Williams Act);

enabling statute represents exactly the form of less restrictive alternative for which commerce clause analysis since *Dean Milk* has properly searched. In the last analysis, to treat enabling legislation the same as mandatory legislation, because identical restraints can be adopted under each, is to mistake an ox for a bull.

The option of private shareholder action also casts the mandatory Indiana and Ohio statutes in a different light. If the burden is on the state to justify any substantial restraint on interstate commerce, and if less restrictive alternatives are available in the form of shareholder-approved charter amendments, it is difficult to see how a state can meet the burden of justifying restraints such as those imposed by the Indiana and Ohio statutes, *unless* some claim is seriously made that such legislation is intended to benefit nonshareholder constituencies. This resolution also places on the state the burden of proving a justifiable intent and so minimizes the judicial problems inherent in attempting to infer a discriminatory intent.

To summarize: state takeover statutes should be evaluated according to a two-step analysis. If a claim is raised of benefit to some nonshareholder constituency, this claim, if meritorious, should be balanced against the burden on interstate commerce according to the basically deferential standard articulated in *Pike v. Bruce Church, Inc.*²⁹¹ *Edgar* was correct in relying on *Pike* as its central authority, but short-sighted in believing that *Pike*'s test required invalidation of any statute that regulates transactions between out-of-state shareholders. What *Edgar* essentially missed is that, although the state has no legitimate claim to "protect" out-of-state shareholders, it can have a legitimate right to restrain them when it is seeking to protect the interests of other constituencies interested in the corporation.

When no claim is made that legislation is intended to achieve such a goal, a heavy burden should fall on the state under *Dean Milk* to show why, if its only intent was to protect shareholders, it did not adopt the less restrictive alternative of enacting enabling legislation that authorized the shareholders to protect themselves. Because management controls the proxy machinery it always has this option, and it can hardly claim that its fear the shareholders would reject such a proposal justifies state regulation. Under this test, the Indiana and Ohio statutes seem highly suspect, although identical or even more formidable barriers could instead be erected by private action, which the state could specifically authorize by statute.

Moran v. Household Intl., Inc., 500 A.2d 1346, 1353 (Del. 1985) (neither commerce clause nor supremacy clause offended by private action restricting transferability of shares).

291. 397 U.S. 137 (1970).

CONCLUSION: TOWARD A PUBLIC LAW PERSPECTIVE

Shareholder wealth and social wealth are not synonymous. The former can be enhanced in ways that do not increase, and may even decrease, the latter. This article has viewed the modern public corporation as an unstable risk-sharing arrangement among managers, employees, creditors, and shareholders, in which implicit bargains that once defined the configuration of their relationships have now come partially undone. At least over a transitional period, wealth transfers are occurring from managers to shareholders, which process logically should affect future managerial behavior. Viewed optimistically, the new wave of takeovers represents a mechanism by which shareholders are at last able to counteract management's inherent bias toward risk aversion and excessive earnings retention. In this view, the takeover movement has begun to purge the modern corporation of the organizational slack and high agency costs on which an earlier generation of managerialist critics had focused. Viewed more pessimistically, however, there may be social costs associated with this newfound shareholder power, because society as a whole may share the manager's aversion toward risk or may benefit from his investment in firm-specific human capital. These rival views are not necessarily inconsistent, and both may be correct.

Important issues have a tendency to present themselves as questions of both equity and efficiency. The takeover movement is a case in point. The paradigm issue of equity arises in the case where an acquiring firm (say, Chevron) buys the target (say, Gulf) and then dismisses a substantial portion of the target's managerial staff in the aftermath of the acquisition.²⁹² The losses incurred by the target employees are obviously significant, but the gains received by the target shareholders are probably substantially greater.²⁹³ If part of the gain can thus be considered a wealth transfer from employees to shareholders, a normative issue surfaces: is it equitable for the law to facilitate

292. See notes 15 & 131 *supra*.

293. Sometimes, however, the capitalized value of the layoffs occurring in the wake of a takeover may equal the total premium paid to the shareholders. Salter and Weinhold argue that in the acquisition of The Continental Group by Peter Kiewit & Sons, the capitalized value of the salary expense saved as a result chiefly of dismissing the senior managerial team of Continental equalled the premium paid to the target shareholders. See M. Salter & W. Weinhold, *supra* note 231, at 17. In such a case, it would seem that simply a wealth transfer is occurring, with no enhancement of economic efficiency. However, even in these cases, the loss to employees is probably still less than the gain to the target shareholders, because most employees will eventually secure employment elsewhere, although possibly at a reduced salary; thus, they do not lose the full capitalized value of their salary. The marginal utility of money further clouds any attempt at interpersonal comparisons of welfare, because an extreme loss to a few may outweigh a modest gain to many. Still, for the view that takeover-induced layoffs reduced GNP in the United States during 1985 by between 0.5% and 1%, see note 14 *supra*.

such wealth transfers to shareholders from nonshareholder classes? Neoclassical economic theory would answer yes, based on the Kaldor-Hicks definition of efficiency: that is, because the gains exceed the losses, the transaction is "efficient" and should be encouraged, on the rationale that the losers can be compensated by some other means (such as by the state).²⁹⁴ The obvious problem with this theory is that the losers will generally not be so compensated, and the state may not be able to undertake complex programs of wealth redistribution. However, it is in the interests of shareholders themselves to compensate managers because their potential gains appear to exceed the latter's potential losses. As a result, economic theory suggests a compromise that both mitigates the equity issue and also satisfies the efficiency criterion: society should encourage the "winners" to "bribe" the "losers." This is, of course, the standard Coasean prediction of what would occur in the absence of high transaction costs;²⁹⁵ here, it implies that the obvious "winners" from takeovers (the target shareholders) can secure the acquiescence of the clearest losers (the target employees) either by paying them substantial termination payments ("golden parachutes") or by granting them preferential assistance in formulating a counterbid (the "LBO").

The propriety of encouraging side payments from shareholders to managers in any form may seem troubling to many on ethical grounds. Yet, as this article has stressed, there is a substantial case for such payments to the extent that they compensate managers for their investment of firm-specific capital and also honor an implicit contract that the new wave of takeovers has disrupted. To say this is not to

294. Economic theory usually avoids the question of equity by assuming only that "more is better than less." This is the basic notion of Pareto efficiency, which assumes that a change or transaction that makes some better off and none worse off is efficient. What happens, however, if there are both winners and losers? The Kaldor-Hicks approach postulates that if the gains exceed the losses, the transaction or legal change giving rise to this net gain is efficient because the winners can compensate the losers for their losses and still come out ahead. See Hicks, *The Foundation of Welfare Economics*, 49 ECON. J. 696 (1939); see also A.M. POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 7-10, 115-17 (1983).

295. The Coase Theorem, which is at the core of neoclassical economics, postulates that in the absence of high transaction costs the parties will bargain to the efficient solution, because in effect the "winners" will bribe the "losers." See Coase, *The Problem of Social Cost*, 4 J.L. & ECON. 1 (1960). Proponents of this view often argue that where transaction costs are high, the law should "mimic" what the market would otherwise have accomplished. In light of this Coasean answer that shareholders should "bribe" managers into acquiescence, it is curious that Easterbrook and Fischel, as leading proponents of a neoclassical approach to law, argue for a rule of passivity. See Easterbrook & Fischel, *supra* note 34 (arguing that managers should remain passive in takeovers). The Easterbrook and Fischel position seems anti-Coasean because it relies on judicial action rather than bargaining among the participants. Although this article does not dispute the need for judicial oversight, it would recommend relaxing some of the barriers to a Coasean solution through the payment of "change of control" compensation to managers.

accept all such payments, however excessive or egregious, nor is it to reject the need for judicial monitoring of other defensive tactics. But the efficacy of such judicial monitoring remains in doubt, and there would thus seem to be every reason to employ positive incentives, as well as negative ones, to obtain management's acquiescence. More generally, a policy of premium sharing seems vastly preferable to the other obvious alternative open to management: namely, attempting to lock up voting control in its own hands through the issuance of dual-class common stock.²⁹⁶ The policy options here favored — premium sharing and greater tolerance for LBOs — can thus be justified as an expression of preference for allowing management to buy control or to share in the sale of control proceeds, as against allowing it to acquire voting control through techniques that do not result in equivalent payments to shareholders.

From a social cost perspective, an unnecessary "dead weight" loss is incurred by society when amounts as high as \$200 million are incurred as transaction expenses incident to a single takeover.²⁹⁷ One need not be a cynic to observe that amounts considerably below this level might encourage the vast majority of American management either to accept a takeover gracefully or instead to compete only in a manner that maximizes values for shareholders, such as by formulating a rival bid through an LBO.²⁹⁸ If outright resistance thus gave

296. Dual-class common stock refers to the use of "supervoting" stock having multiple votes per share (usually ten). Such stock may be issued with either low dividend rights or with restrictions on its alienability, so that the stock expressly loses its "supervoting" characteristic on transfer. As a result, the supervoting stock tends to become disproportionately held by management or a controlling group of shareholders (usually a family), which is, of course, the intended result. The practical consequence of dual-class common is thus not premium sharing, but premium conversion, because eventually those holding the voting rights can sell their shares (or cause a merger to be approved) at a price or exchange ratio more favorable to them than to the other common class. Recently, the New York Stock Exchange has reversed a long-standing policy and approved the listing of dual-class common. See Seligman, *supra* note 209.

297. Pantry Pride paid approximately \$1.7 billion to the stockholders of Revlon, but incurred total costs of \$2.7 billion, including "some \$200 million in expenses for lawyers, investment bankers and severance payments." See Cole, *Takeover Accepted By Revlon*, N.Y. Times, Nov. 2, 1985, at 35, col. 6, 37, col. 1. While this \$200 million figure presumably includes the \$35 million paid to Michael Bergerac, the former CEO of Revlon, it apparently includes even greater amounts paid to Pantry Pride's lawyers and investment bankers. Thus, the interesting question is whether, on average, increasing severance payments would produce more than offsetting savings in terms of the expenses incident to a hostile takeover battle (in comparison with a "friendly" acquisition). Arguably, a rule that liberalized "change of control" compensation would cause a wealth transfer from lawyers and investment bankers, who today profit enormously from takeovers, to managers, who today lose.

298. Judge Posner has expressed a similar view that generous severance compensation should reduce managerial opposition to takeovers. *Dynamics Corp. of America v. CTS Corp.*, 794 F.2d 250, 254 (7th Cir.), *prob. juris. noted*, 107 S. Ct. 258 (1986). Of course, some incentive for opposition will remain, but a measure of managerial opposition may be optimal, because a wholly passive management would not resist a low premium bid, when the shareholders' interests may be best served by seeking to create an auction.

way to either acquiescence or an auction contest, society would realize substantial cost savings, shareholders might receive even higher takeover premiums as the result of more prevalent or sustained auctions, and courts would be less burdened by takeover litigation.

The real difficulty with this proposal is a noneconomic one: the payment of vast sums to senior managers to encourage them to leave gracefully may appear indecent and even corrupting. In response, the practical standard recommended by this article is the adoption of an equality side constraint. By requiring that "change of control" compensation observe nondiscrimination rules that are analogous to those applicable to pension plans, one mitigates this problem and achieves a rough justice by linking the interests of senior and middle management. Given the *de facto* ceiling on such compensation set by the Internal Revenue Code,²⁹⁹ a nondiscrimination rule essentially supplies a floor to match the Code's ceiling. If a requirement of shareholder ratification were substituted for the current "trebled salary" ceiling, there would seem to be little reason to retain any ceiling on such compensation, other than the common law's traditional waste standard.³⁰⁰ To be sure, any constraint that limits the maximum "change of control" compensation that senior managers could receive, by a formula that links their interests with those of middle management, works against the above-stated Coasean rationale, because it reduces the side payment that can be made to those able to block the transaction. But it is the middle manager who today seems most exposed to a loss of human capital and who is most likely to be left out in the settling-up that frequently occurs at the twelfth hour of a takeover contest.

Ultimately, there is a curious irony about the implications of this article's analysis. For decades, reformers from Adolf Berle to Ralph Nader have sought to increase the power of shareholders to control corporate managers by a variety of means, including increased disclosures, independent directors, and reform of the proxy process. The advent of the hostile takeover may have succeeded in reducing "agency costs" beyond their wildest dreams. Yet, the end result is problematic, because for at least some of these reformers the motivation underlying their pursuit of increased shareholder power was the assumption that shareholders had interests and values that coincided

299. See notes 213-15 *supra* and accompanying text. Admittedly, there have been cases in which this trebled salary has been exceeded. See note 213 *supra* (discussing recent "golden parachutes" awarded by Beatrice Cos.). Case law may have begun, however, to restrict such payments. See cases cited at note 212 *supra*.

300. The "waste" standard is a permissive one. See *Lieberman v. Becker*, 155 A.2d 596 (Del. 1959); *Bergstein v. Texas Intl. Co.*, 453 A.2d 467 (Del. Ch. 1982); see also *Beard v. Elster*, 160 A.2d 731, 736 (Del. 1960).

with those of the unrepresented constituencies they chiefly wished to protect (such as local communities, the poor, or the environment). Even if this assumed identity of interests proved tactically useful in some instances, it has become intellectually untenable in the current era of the bust-up takeover. The point is not simply that shareholders cannot be equated with widows, orphans, and the socially dispossessed, but that when the issue of risk is at center stage, a closer identity of interests may exist among managers, employees, and the community of unrepresented interests that surround the corporation and depend upon its solvency. Managers and these other constituencies share the common circumstances of a nondiversifiable investment in the corporation that makes them risk averse. Reform of corporate governance should proceed then not on the assumption that potentially "reckless" managers need to be restrained by controls that protect shareholders who want a prudent, conservative management, but rather on the recognition that the biases of the participants are today closer to the reverse.

In this light, the flaw in the "second generation" of state takeover statutes and similar attempts to restrict takeovers has been their continued pretense that they are intended only to "protect" shareholders. This argument becomes hollow as soon as one realizes that shareholders could have adopted their provisions by private action through charter amendments, had they desired to do so. But a bad argument does not necessarily imply a bad objective. Whether or not effective in their current form, statutes such as New York's five-year ban on a merger following a hostile takeover are clearly intended to serve interests other than those of shareholders, and probably are easier to defend against a commerce clause attack when they are rested on such a general welfare foundation.³⁰¹ Ultimately, only a public law perspective can provide a coherent framework within which restrictions on takeovers can be justified.

From that perspective, the long-standing tendency for reformers to identify with the shareholders' interests on all questions of corporate governance today appears more reflexive than thoughtful. In the British Foreign Office of the nineteenth century, the maxim was that "there are no permanent alliances, only permanent interests." On the topic of takeovers, it may be that the more natural alliance today is between managers and those who fear the social dislocations and other potential externalities that the takeover movement can bring about. This article does not suggest that this alliance should be permitted to

301. See notes 272-91 *supra* and accompanying text.

block takeovers or to prevent an overdue restructuring of the American corporation, but a policy of premium sharing and a common focus on the social costs of excessive risk taking would constitute a sensible agenda. To say that managers should be accountable to the market only begins the analysis. The problematic downside to this glib norm is that a volatile market can be a fickle master who may regularly override the superior judgment of his manager-servant. Thus, the central question from a public law perspective is how much accountability is too much.